An Examination of Company Law's Deference to Directors' Business Decisions: A New Perspective

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ABSTRACT

The UK judges defer to company directors' certain type of business decision and thereby, insulate them from excessive standard of judicial scrutiny. However, the definition of the type of executive discretion that qualifies for company law deference has long been uncertain. The UK judges take the view that, as judges, they are 'ill-equipped' (similar to the term – 'that judges are not business experts' used by the US courts in justifying their common law-derived business judgment rule) to second-guess those decisions, without a clear explanation as to the precise meaning of the term. The lack of clarity leads to the long-standing misconceptions amongst the academics and the practitioners citing the judges' insufficient business expertise as a reason. This thesis sets out to map the relevant law. It offers some meaningful insights into how company law deference functions, by reviewing the types of business decisions through psychology, and to a lesser extent, economics. Case studies are undertaken to give an in-depth illustration, from a psychology perspective, on the types of business decisions eligible for company law deference. This thesis gives a critical evaluation of the customary view questioning judges' business expertise as a justification for courts' deference. It submits that, in practice, the judges focus on the dichotomy between directors' business creativity and corporate governance functions. Showing contrast between the so-called 'programmed' and 'non-programmed' decisions in the context of courts' deference to executive discretion. It is this taxonomy that is both doctrinally and normatively dispositive to the courts' approach. This thesis also submits that the law plays an important role in yielding appositive impact on motivation of company directors' business creativity. This interdisciplinary research involving the relevant law, psychology and economics leads to a useful mechanism, capable of identifying or predicting the types of business decisions for the application of the courts' deference.

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ABBREVIATIONS

CPR	Civil Procedure Rules
US	United States of America
UK	United Kingdom

DECLARATION AND COPYRIGHT STATEMENT

DECLARATION:

No portion of the work referred to in this thesis has been submitted in support of an application for another degree or qualification of this or any other university or other institute of learning.

COPYRIGHT STATEMENT:

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I would like to express my sincere gratitude to my supervisor & mentor Dr. Daniel Attenborough for his continuous support. Without his valuable guidance, patience and motivation, creation of this thesis would not have been possible.

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CHAPTER ONE - INTRODUCTION

BACKGROUND

A company in law is regarded as a separate legal entity from its members.[1] This means that it entails the attributes of legal personality[2] in the sense that like a real individual, it has the right to own assets, entering into contracts in its own name or on behalf of a third party.[3] It also has the right to be a plaintiff, defendant or party in legal or insolvency proceedings, for instance, in the case of *Salomon v Salomon and Co Ltd*[4] it was held that creditors of an insolvent company could not sue the members of the company for the company's debt. Instead the creditors had to prove the debt in the company's liquidation. A company therefore, is a trading vehicle to 'provide a legal form which would enable investors to put their money into a business without being responsible for managing it.'[5]

However, as an artificial person, a company is physically incapable to perform its acts, therefore has to have its affairs or business decisions managed and taken through

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[1] 1862 Companies Act, section 18. 5

[2] 'The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscriber or trustee for them.' as per Mcnaghten in *Salomon v Salomon and Co Ltd* [1896] UKHL1 (HL); see also W.E Singleton, 'Entities and Real Artificial Persons' (1912) J Soc Comp Legis Vol 12 No 2 295; and Ivamy E.R.H. *Dictionary of Company Law* (Butterworth Professional Dictionary Series 1983) 43

[3] Mayson, French & Ryan, *Mayson, French & Ryan on Company Law* (34th edn, OUP 2017-2018) 5

[4] [1896] UKHL 1 (HL)

[5] Mayson, French & Ryan, *Mayson, French & Ryan on Company Law* (34th edn, OUP 2017-2018) 425

agents known as directors. In *Ernest v. Nicholls*,[6] the judge stated that,' … for the purposes of contract, the company exists only in the directors and officers acting by and according to the deed [i.e., the deed of settlement, equivalent to those days to the articles of association][7]…' [8]

It is easy to understand that when the director is involved in acts of bad faith including gross negligence, conflict of interest and fraud in the process of his business decision-making, the law will intervene and punish the guilty as a matter of safeguarding the interests of the stakeholders, such as the shareholders and creditors of the company. This principle applies even in countries such as America where judicial deference is normally given to directors that the'…courts will only pass judgment on the wisdom of a board's decision if a transaction is so disadvantageous to the firm that no reasonable person could deem it fair.'[9]

A difficulty that arises as to what legal consequences should a director face when the company sustains a loss whether financially or not as a result of the director's negligence in his business decision. As business decisions are made on behalf of the company by its directors, it is inevitable that directors will make bad business decisions from time to time because 'bad luck is inherent in the nature of uncertain

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[6] [1857] 10 ER 1351 (PC)

[7] Mayson, French & Ryan, *Mayson, French & Ryan on Company Law* (34th edn, OUP 2017-2018) 425

[8] [1857] 10 ER 1351 (PC) [423]

[9] Lynne A. Stout, 'In Praise of Procedure: An Economic and Behavioural Defense of *Smith v. Van Gorkam* and the Business Judgment Rule' (2002) 96 NW U L Rew 675; and see *Grobow v. Perot* 539 A.2d 180, 187 [Del. 1988] for such a guideline for the presumption of business judgment rule.

world.'[10] And because 'business decision invariably involve risk evaluation and assumption.'[11]

Currently, both the UK and the US have adopted, to a certain extent, similar legal regimes governing the fate of a director in this respect; namely, the legal regimes in both of the countries allow the company shareholders to take a derivative claim on behalf the company against the director for negligence. Although, both the UK and the US judges defer to the business decisions of company directors, the respective courts' deference to directors' business decisions is procedurally different. In the UK, derivative claim against company directors can be taken under section 260(3) of Part 11 of the Companies Act 2006 (with the courts having the discretion to apply legislated deference in favour of the company under sections 263(2)(a) and 263(3)(b) of the same Act). Serving as a legal guideline, legislated deference is applied on the basis that no hypothetical director acting in the interest of the company (within the provisions of section 172 (duty to promote the success of the company) - as a benchmark to assess the intention of the shareholder claimant) would continue the derivative claim (sections 263(2)(a) & 263(2)(b)). In the US, the court does not apply the business judgment rule by looking from the perspective of claimant shareholders' intention, rather, the business judgment rule is a rebuttable presumption with the

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[10] Kenneth E. Scott, 'Corporation Law and the American Law Institute Corporate Governance Project' 35 Stan L Rev 927, 936. as cited by Franklin A. Gevurtz, *Corporation Law* (2edn, West Academic Publishing 2010) Chapter 4

[11] Herbert S. Wander and Alain G. LeCoque, 'Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule' (1986-1987) 42 Bus Law 29

burden upon the shareholder claimants to prove 'directors, in reaching their challenged decisions, breach any one of the triads of - good faith, loyalty or due care'.[12] In other words, the shareholder claimants must successfully demonstrate that in making such a business decision, the director has either acted in bad faith (not in the best interest of the company); wastefully; on uninformed basis; and/or acting self-servingly.[13]

On the other end of the spectrum, strict application of derivative lawsuit in the absence of the possibility of judicial or legislated deference would serve, from a psychology perspective, as a mechanism for 'punishment' and might ensure certain degree of carefulness on the part of the directors. However, from a psychology perspective, the **absence** of judicial or legislated deference of which the court could apply within a set of legal guidelines, will arguably undermine and de-motivate company directors from appropriate risk-taking, invariably is an essential element to the business creativity that promotes the success of the company.[14]

Judicial or legislated deference, on the other hand, allows the directors to take business risks without the fear of liability for negligence with the benefit, from the psychology perspective, of motivating business creativity.

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[12] Cede & Co v. Technicolor, Inc [Del. 1993] 634 A.2d 361

[13] *Grobow v. Perot* 539 A.2d 180, 187 [Del. 1988]

[14] Taylor H. Cox and Stacy Blake, *'Managing Cultural Diversity: Implication for Organisation Competitiveness' The Executive* (Vol 5 No. 3 1991) 50; A. Toynbee, 'Has America Neglected Her Creative Minority?' (1962) Editorial Projects in Education 8; and Andrall Pearson, 'Tough-Minded Way to Get Innovative' (May/June 1988) HBR 66 No 3, 99

The objective of this research, as part of my contribution to knowledge, will be to critically examine the UK judicial and legislated deference from a psychology perspective; and demonstrates that such a legal regime offers a psychological advantage of achieving motivation on company directors. This in turn, enables company directors to maximize their business creativity in the best interest of companies. Company directors, as human beings, are prone to making errors in exercising their duty of care and skills within the context of business decision-making, with the consequence of yielding an adverse effect against the company and the shareholders. It is inevitable, that appropriate level of legal tolerance to business risk-taking must exist.

To achieve the objective, the thesis will provide a critical evaluation of the doctrinal UK law relating to directors' duty of care and skill in the context of their business decisions. In doing so, the research will be based on both the common law and the statutes which allow the law to be fully traced and studied.

The thesis will demonstrate the significance of creativity in directors' business decision to the company by way of the relevant economics studies with the support of some relevant case laws.

It will be argued by this thesis, the law, from a psychology perspective, is acting as a motivator to allow directors to fully engage in proper creative business decision-making. This is essentially done by way of judicial or legislated deference to

sufficiently insulate company directors from negligence liability. This thesis will evaluate and identify business creativity being the factor underpinning proper judicial or legislated deference to directors' decision-making and highlight business decisions that will not receive that protection.

Part of my contribution to knowledge in this thesis will be to critically demonstrate that the UK legal regime provides a both doctrinal and normative approach to judicial or legislated deference relating to company directors' business judgments. This is based on, from the psychology perspective, the types of business decisions underpinned by the policy argument based on the psychology theories of business creativity. In other words, this thesis will produce the end result of linking the psychology theories of motivation, creativity and types of business decisions to the judicial or legislated deference, which in turn, gives a new perspective of the legal regime beyond the exclusive perspective of the law. It also evaluates the justification of the law, from a psychology perspective; and examines the psychology value of the law in motivating directors' business creativity.

Through the combination of the law and other disciplines, this thesis will design a formula based on the Non-Programmed (Creative) Business Decision to 'calculate' and identify the types of business decisions, i.e., business judgments for the purpose of the application of judicial or legislated deference. The author acknowledges that business judgments are of unique nature and can, in rare cases, be subject to the 'borderline' situation where the business judgment is ambivalent through the case law

decisions.[15] The proposed formula, thus can appear to be limited by such ambivalence. Case studies have therefore been used in Chapter Five to demonstrate the effectiveness of the formula in identifying types of business decisions within the scope as wide as possible.

To sum up, a big part of the originality of this research lies in an analysis of the policy arguments for proper judicial or legislated deference in combination with a number of external disciplines, namely, psychology (and to a lesser extent, the economic) theories relating to motivation and creativity in the context of directors' business decision-making. In particular, the psychology theories known as intrinsic and extrinsic motivators, as well as, the types of business decision-making theory of H.A Simon and other scholars in the field. A formula will be created to assist the identification of types of business decisions for the purpose of the application of juridical and legislated deference.

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[15] As mentioned by Keay A & Loughrey J, 'The Concept of Business Judgment' Legal Studies 1, 11 <https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019; see Chapter Two for more relevant discussion.

JUDICIAL OR LEGISLATED DEFERENCE, CREATIVITY AND TYPES OF BUSINESS DECISIONS

In examining the origins of judicial and legislated deference within the English legal system, academic writers have generally placed their discussion on its history. References to English law cases have been made to discuss when judicial deference first and continuously appears in the English legal system and in turn, has shed some light on the origin of judicial deference in English law, i.e., judicial deference was originated from common law and subsequently codified into the Companies Act 2006.

The current statutory system relating to directors' duty of care and skill based on Section 174 of the Companies Act 2006 representing a codification of the relevant common law. The derivative claim being set out in Part 11 of the Companies Act 2006. Both have been directly or indirectly discussed which bring out a clearer picture on the scope and application of legislated deference. The application of legislated deference is based on the hypothetical director test adopted by the court. The test is used to see if the continuation of the derivative claim is in the interest of the company.

As the UK legislated deference, in certain levels, bears a striking resemblance to the US business judgment rule (as Chapter Two of this thesis will show), the materials relating to business judgment rule and liability for negligence represents part of the core of my research as there are a large amount of relevant materials available for this

research. It has been academically put forward in favour of business judgment rule protecting company directors against negligence liability by primarily relying on the understanding of the literal meaning of the arguments that judges are not business experts; and bounded rationality being the justifications of business judgment rule. The traditional factor justifying judicial deference on directors' business decision based on the literal meaning that judges are not business expert has been put forward historically by judges and academic writers. One of the most prominent writers in recent years is Bainbridge who has discussed that judges have relatively less general business expertise than company directors, therefore, are not capable to judicially review the company directors' business decision.[16] Bainbridge has cited judges' and other writers' comments to support this argument.[17] For instance, In *Dodge v. Ford Motor Co* where the judge remarked that 'the judges are not business experts.'[18]; and academic writers such as Posner have stated that 'Courts have trouble understanding the simplest of business relationships … judges must be generalists but they usually have narrow background in a particular field of law.'[19]

This thesis will demonstrate the correct interpretation of the traditional factors justifying judicial deference. In other words, this thesis will show that when the judge

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[16] Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 83, 117

[17] ibid

[18] [1919] 170 NW 668 684

[19] 'A Theory of Contract Law under Conditions of Radical Judicial Errors' (2000) 94 NW UL Rev 758

cited 'judges are not business experts' or judges are 'ill-equipped …'[20], the judges were actually referring to the business creativity of directors' business decision-making; and not the amount of business expertise possessed by the judicial system. This thesis will lead to the conclusion that the policy argument underpinning judicial or legislated deference is therefore, placed on motivation, creativity and types of business decisions (see below for further elaboration).

When it comes to types of business decisions within the context of directors' business creativity, academic comparisons have historically been made, in the US legal studies, to demonstrate the difference between judges being able to deal with cases involving other professions', such as medical practitioners' decisions as opposed to company directors' business decisions, is that medical practitioners' decisions are regulated by their code of conduct that serves as a benchmark for judges to refer to when judging the cases for medical mal-practice. Such a benchmark, at the same time, also allows the defendants to defend the quality of their professional decisions. On the other hand, company directors' business decisions are unique in nature and are not regulated by any existing code.

The thesis will demonstrate that such a comparison between company directors' business decision and other professions' is over-simplistic as it is based on the assumption that every director's business decision is unique. However, in reality this

[20] A term with similar meaning to 'judges are not business experts' that has been used by the UK judges to justify legislated deference in cases such as *Iesini v. Westrip Holding Limited* [2010] BCC [85]

one can broadly categorize directors' business decisions into unique and non-unique types. For instance, there can be situations where directors' business decisions were non-unique as the decisions were subject to predefined rules as shown in the case of *Thomas Saunders Partnership v Harvey*[21] where the defendant director's business decision in connection with confirming if the flooring conforms to a particular specifications constituted a decision governed by the predefined standard of flooring measurement; or *Smith v Van Gorkom*[22] where the director was found grossly negligent for not following the pre-define methodology to calculate the share price of the company in a proposed leverage buyout merger. This thesis argues that judges are equipped with the understanding and approach to distinguish the types of directors' business decisions in order to determine whether or not the directors should be offered with protection of judicial or legislated deference. In doing so, this thesis will look, from the psychology perspective, into the types of business decisions that has been distinguished by judges. From a technical perspective and to be precise for the purpose of this thesis, the problems associated with the academic assumption of the unique type of directors' business decisions have been identified and dealt with in detail as follows:

1. **Types of business decisions:** the academic assumption, in the legal studies, does not provide a definition of uniqueness. This would arguably present

[21] [1989] 30 Con LR 103 (QB)
[22] 488 A2D 858 [Del. 1985]

difficulties for one to distinguish which business decision is unique and which one is not. To solve this issue, I will adopt H.A Simon's psychology theory of types of business decisions to bring out much clearer than has been done so far as to the nuances on the type of business decision is concerned within the context of judicial or legislated deference;

2. **The absence of the 'benefit' as a component in the definition of unique business decisions:** The adoption of the psychology theory of types of decisions alone is not sufficient to answer the question as to what a unique or creative business decision is. This is because the psychology theory of types of business decisions does not have the component of 'benefit' which is the essential element in a company director's business decision. The component of 'benefit' is essential because, from the legal perspective, a director would have to act in the interest of the company; and
3. **Motivation:** the theory of types of business decisions on its own is not inherently linked to the psychology concept of motivation. This thesis will show that the psychology concept of motivation is a central component to demonstrate the difference between non-business expert judges and non-business expert directors within the context of business decisions for the purpose of achieving a correct interpretation of the justification for deference.

To fill the gaps (as identified above) left by the US law academic assumption that relating to the uniqueness of all directors' business decisions, this thesis combines the psychology theories of both types of business decisions proposed by H.A Simon; and creativity proposed by T.M Amabile. The result, this thesis makes the combination of both of the theories into a new concept known as judicial or legislated deference based on the Non-Programmed (Creative) Business Decisions.

SIGNIFICANCE OF BUSINESS CREATIVITY

Another aspect of this thesis is to review the existing argument that judicial intervention by way of derivative lawsuit as to the substance of the directors' business decisions will discourage the directors from entrepreneurial risk-taking to the detriment of the company. This thesis will identify business risk-taking, from the psychology perspective, as business creativity. This thesis will argue that whilst putting strong emphasis on risk-taking, the existing argument has not explained fully, the significance of risk-taking to the company. In other words, 'preaching' the fear that directors would become business risk-averse as a result of judicial intervention without the prior understanding the benefits of risk-taking (i.e., business creativity) to a company is meaningless.

Part of Chapter Four will, therefore, be dedicated to examine the existing arguments relating to the significance of business creativity underpinning the concept of judicial or legislated deference based on Non-Programmed (Creative) Business Decisions. Briefly I will mention, the significance of business creativity to a company as

including: increased customer loyalty and developing unique selling points, maximising resources, responding to trends and competition; and developing new selling points to build positive branding image and secure business loyalty.

PSYCHOLOGY DEFINITIONS OF CREATIVITY

The issue on the proposed models of creativity, namely, the personality-oriented measure or the product-oriented measure to be adopted in one's field of creativity research has been a subject of discussion in psychology. The Product-Oriented Measure as a definition of creativity represents a widely used definition in the relevant field of studies. I too have selected the Product-Oriented Measure as a defining component of my concept of Non-Programmed (Creativity) Business Decision because of its suitability to my research. As the components of the Product-Oriented Measure of Creativity, namely, the 'novelty' and 'usefulness' do not involve any unnecessary complexity and can be suitably used to define a company directors' business creativity. These are the required qualities that the Personality-Oriented Measure of Creativity with which the assessment is mainly placed on the personality traits of the test subject does not have.

DIFFERENT THEORIES IN MOTIVATION

The existing law studies have not explained with in-depth precisions as to how the directors can be discouraged from being business creative or why the directors are more business creative than the judiciary. This thesis argues that the answer to these questions can be found in psychology theory of motivation. This thesis will use the

theory of intrinsic and extrinsic motivators to demonstrate that the directors are prone to be motivated to be creative as opposed to judges. This is because judges are bound by a number of judicial constraints and are only generally concerned about deciding the quality of the decision within the context of duty of care. This in turn supports the psychology argument in favour of the courts' current position that Non-Programmed (Creative) Business Decisions are not meant to be second-guessed by judges irrespective of their business expertise.

This thesis will also adopt other motivation models such as Maslow's Hierarchy of Needs to strengthen the Intrinsic and Extrinsic motivation theory. This thesis shows the understanding that Maslow's Hierarchy of Needs has been criticised for not being a model that reflects the hierarchical order universally between difference societies. Whilst accepting the criticism, this thesis argues that the model bears direct relevance to the research. The criticisms of the hierarchy of needs do not apply to the conditions set in this thesis, for instance, 1. the theory of hierarchy of needs is arguably not applicable to the society based on collectivism such as fascism or Maoism all of which do not represent the social circumstances of countries like the UK and the US; or 2. the argument that the role of sex has not been placed in Maslow's hierarchy; however, this criticism bears no relation whatsoever to this thesis.

On the English side, some existing academic studies have proposed that shareholders' power of ratification over the director's negligence (subject to the limitations, such as decisions made legally) (sections 239); the court's discretion to relieve a director from

negligence claim (section 1157);[23] and the grounds for the derivative claims (section 260) respectively within the Companies Act 2006 are equivalent to the American concept of judicial deference leading to their conclusions that - since there has been a common law 'implied' business judgment rule in the UK (which has now mostly been enacted into the Companies Act 2006) an overt business judgment rule will create 'mischief' to the existing system.

An element of uncertainty exists within UK company law, as whilst academic concerns have been raised over the widening scope of derivative claim against company directors through negligence under Sections 174 and 260 without expressly incorporating into the statute, the common law 'implied business judgment rule' such as the internal management rule set in the case of *Burland v. Earle*[24] or the requirement that directors had to benefit personally from the business decision (*Daniels v. Daniels*[25]& *Pavlides v. Jensen*[26]); and by allowing shareholders, for instance, to bring a derivative claim under the Companies Act without the need to demonstrate that the directors own a majority of shares in the company, would all inevitably make directors to feel more threatened; other writers such as Moore[27] continues to express the faith in the British legal system, maintaining that company

[23] As the rationale of the Companies Act, section 1157 is for the court to exercise its discretion to relieve directors from liability rather than a mere deference to their managerial decision. This thesis will therefore not cover this section as it is not strictly a form of judicial deference within its scope.
[24] [1902] AC 83 (PC)
[25] [1978] CH 406 (Ch)
[26] [1956] 2 WLR 224 (Ch)
[27] Moore on Corporate Governance in the Shadow of the State (Hart Publishing 2013).

directors are no more exposed to negligence liability under the new system than the common law because of shareholders' power of ratification and the court's discretion to grant the relieve to directors. Chapter Two of this thesis will discuss the courts' deferential approach by way of discontinuing derivative action under sections 263(2)(a) & 263(3)(b); and the similarities of such a legislated deference to the US business judgment rule.

My thesis will demonstrate that 1. the uncertainty of the law will inhibit creativity and result in the wrong types of 'diligence' or 'risk-taking' to the detriment of the company (Conard); and 2. the English legislated deference under part 11 of Companies Act 2006 offers company directors a satisfactory degree of protection and, from a psychology perspective, promotes directors' intrinsic motivation that leads to their business creativity.

Similar to what this thesis set out to achieve, i.e., examining judicial or legislated deference from, a psychology perspective, creativity, motivation and types of business decisions with analysis of cases laws from the UK and the US, Keay and Loughrey have in their very recent online article attempted to address the question on what a business judgment is by reference to the UK, the US and Australian laws. They borrowed the Knight's concept of entrepreneurial judgment leading to the conclusion that the directors' business decision that falls within the meaning of Knight's concept of entrepreneurial judgment is the type of business decision to be deemed as business judgment. The other types of business decisions that are of

'corporate governance functions' have not been deemed by the courts as entrepreneurial and thus 'are less likely to be viewed as business judgment'.[28]

METHODOLOGY

My concept of judicial deference based on types of business decisions and the doctrine of creativity is inspired by the combination of English and American law with theoretical thinking of various writers and researchers such as Teresa Amabile on the theory of creativity and Herbert A. Simon's theory of programmed and non-programmed decisions.

Comparative work in this research is essential as the concept of judicial deference is a well-developed component in US company law that can be used as part of my analysis in achieving the understanding of the advantages and disadvantages of the relevant UK law. In doing so, my research will contrast the positions in the US, UK and to a lesser extent Australia (the country that has in recent years incorporated the American concept of business judgment rules into its statute) and Taiwan (Republic of China) with the recent cases that bears extreme relevance to programmed business decisions. It will bring out much clearer than has been done so far the nuances of when and how deference may be applied.

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[28] Keay A & Loughrey J, 'The Concept of Business Judgment' Legal Studies 1 < https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019

By doing that, this thesis will evaluate, from psychology perspective as to how successful the UK regime is in line with motivation and business creativity in the context of company directors' business decision making.

Case studies method is defined by Thomas as

> Case studies are analysis of persons, events, decisions, periods, projects, policies, institutions, or other systems that are studied holistically by one or more method. The case that is the subject of inquiry will be an instance of a class of phenomena that provides an analytical frame – an object- within which the study is conducted and which the case illuminates and explicates.[29]

An experimental demonstration will be carried out with a number of case studies in Chapters Four and Five leading to the conclusion that the concept designed serves as an effective tool in identifying the different types of business decisions available, e.g., Non-Programmed (Creative) Business Decisions; and programmed business decisions.

One advantage of carrying out this research is that there is no language barrier as both English law, US law and other areas of disciplines such as psychology adopt English as their primary language.

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[29] Thomas G, 'Sonia is typing..... A typology for the case study in social science following a review of definition, discourse and structure' (2011) QUINFS 17 (6) 511 as cited in https://en.wikipedia.org/wiki/Case_study. > accessed in 23rd July 2017

To assist me to implement the above methods, my research is data-based, seeking the information in the forms of the relevant journals' articles, law, psychology and management text books, law case reports, legal dictionary, historical records and legislations. The relevant materials for my research have been obtained or are obtainable via libraries and internet data-bases such as Westlaw (English data-base - http://legalresearch.westlaw.co.uk/) Heinonline (an American data-base - http://home.heinonline.org/), Lexis Nexis (American, English and Australian database. - http://www.lexisnexis.com/hottopics/lnacademic/) JSTOR (http://www.jstor.org/) psycINFO (Behavioural and Social Science – http:/www.apa.org/pubs/databases/psycinfo/index.axps) and Laws and Regulation Database of Republic of China – Taiwanese law database (New Society for Taiwan) (http://www.taiwansig.tw).

STRUCTURE OF THE THESIS

Chapter 1: This chapter has presented an introduction including the description of the scope of research, research questions to be answered, in particular, the question as to whether or not business creativity represents the central factor governing the application of judicial deference. This chapter has given relevant overviews of the current regimes governing directors' business decision-making in the USA and UK; the psychology studies relating to creativity, motivation, types of business decisions.

How each of these theories relate to judicial or legislated deference in the context of company directors' business decision-making; and the methodology of my research.

Chapter 2: This will analyse the different doctrinal concepts of UK and lesser extent, the American law, that are relevant to judicial evaluations of directors' business decisions. This seeks to trace and answer the question as to the existence, origins and scope of judicial deference as well as legislated deference within the UK law to business decisions in the context of duty of care and skill cases. It will consider the relationship between judging the process by which directors take decisions and the substantive outcome of those decisions.

Chapter 3: This will critically examine the underlying arguments proposed to support judicial and legislated deference to demonstrate the necessity of new theoretical underpinning of judicial and legislated deference in the context of company directors' business decision-making. It will include analysis of the traditional factors, namely, that judges are not business experts and bounded rationality; and the real factor, i.e., company directors' business creativity.

Chapter 4: This will demonstrate, from an economics perspective, the significance of the theory of creativity and innovation in business decision-making. This also adopts the normative approach as It will critically analyse the value of the law, from the psychology perspective. It will explore the psychology theories of creativity and motivation; and how motivation underpins creativity.

Chapter 5: This will demonstrate the different types of business decisions such as Programmed, Non-Programmed, Hybrid and the Evolution of types of business decisions. This will discuss the inter-relation of creativity and motivation with each type of the business decisions and it will also contain a discussion as to their suitability for the application of judicial or legislated deference. Linking to Chapter Four, this chapter will essentially demonstrate, from a psychology perspective, that company directors' agency problems[30] relating to making of their Non-Programmed (Creative) Business Decisions cannot be overcome by derivative claims. This chapter will discuss the counter-strategies that can be adopted against company directors' agency problems in the absence of judicial intervention on company directors' Non-Programmed (Creative) Business Decisions.

Chapter 6: This will be a concluding chapter, which will draw together the preceding arguments leading the conclusion that UK judicial deference; and legislated deference under Part 11 of the Companies Act 2006 have been set out in line with the psychology theories of motivation, business creativity and types of business decisions.

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[30] An agency problem/agency Cost is '… economic concept concerning the cost to a 'principal' (an organization, person or group of persons), when the principal chooses or hires an 'agent' to act on its behalf. Because the two parties have different interests and the agent who has the access to and control of more relevant information, the principal cannot directly ensure that its agent is always acting in its (the principals') best interests.' Lucian Bebchuk and Jesse Fried, *Pay Without Performance* (Harvard University Press 2004) (Preface and Introduction)

CHAPTER TWO - MAPPING BRITISH JUDICIAL DEFERENCE

CHAPTER INTRODUCTION

Unlike the term Business Judgment Rule - the American concept of judicial deference which is readily and expressly enshrined within its regime of company directors' negligence in the context of their business decisions, British law does not have a set of rules with such a term. However, this does not mean that the British legal system refrains from insulating directors from negligence liability. Quite the contrary, traces of judicial and legislated deference can be found 'scattering' within the Common Law prior to the Companies Act 2006 and the Companies Act 2006 respectively.

The concept of directors' negligence liability is being dealt with under Section 174 Companies Act 2006. This concept includes the standard of conduct for the assessment of negligence liability. And it represents a direct codification of the relevant common law[31] (*Re City Equitable Fire Insurance Co*[32]; & *Dorchester Finance Co v Stebbing*[33]). It follows that, in order to fully trace the UK legislated

[31] Companies Act 2006, Section 170(3) which states that company directors' general statutory duties are … based on certain common law rules and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duty owed to a company by a director. This codification has also been noted by text books and journals, see for example, Sheikh, *Company Hand Book* (Bloomsbury Professional 2016) 549; Mayson and French and Ryan, *Company Law* (34th edn, OUP Oxford 2017-2018) 473; Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) ICCLR 22(2) 31-41

[32] [1925] CH 407 (CA)

[33] [1989] BCLC 498 (Ch)

deference and its extent, it is important to have an overall understanding of the negligence regime under the 2006 Act. And to achieve the understanding, one has to first trace back to the historical development of the relevant common law. This is because with the statuary codification, the common law has become an essential instrument for the interpretation of the standard now shown in the statute.[34] In addition, it is also paramount to examine other aspects of the relevant common law and the equitable principles including the rule of wrongdoer's control that has not officially been codified into the 2006 Act; and the consequential impact of its abolition on the UK common law judicial deference. All are aimed to achieve a better understanding of the expected interpretation of the directors' general duties under the Companies Act 2006.

This chapter comprises of research undertaken which seeks to establish the diffidence of the court to interfere with the managerial decisions of company directors through the finding of judicial or legislated deference. This is done with an aim to specifically locate their existence within the relevant British law. This chapter will demonstrate that elements of judicial deference have heavily infiltrated different parts of the British negligence regime, and in order to provide a clear picture to the readers, this

[34] Companies Act 2006, Section 170(4) further states that … The general duties shall be interpreted and applied in the same way as common rules or equitable principles, and regard shall be had to the corresponding common law rules or equitable principles in interpreting and applying the general duties. For instance, in *Kiani v. Cooper* [2010] BCC (Ch) [36], [37] the court applied the subjective test in deciding whether or not the director was acting in good faith to having instructed her husband to covertly transfer certain sum of money from the company's bank account prior to the disputed event.

chapter will divide the whole relevant process through the course of a negligence lawsuit in three different stages. And they are as follows:

- The Course of Negligence Action (Standard of Conduct)
- Enforcement Stage; and
- Post-Negligence Action Stage

Research in each of the above stages/phases will be undertaken to seek to trace and answer the question as to the existence, origins and scope of judicial and legislated deference within the UK law to business decisions in the context of duty of care and skill cases. It will consider the relationship between judging the process by which directors take decisions and the substantive outcomes of those decisions.

The finding of the UK judicial and legislated deference in the context of directors' negligence relating to their business decision is, of essence, to the core of this thesis which is to establish substantively whether or not the whole negligence regime under the 2006 Act is in line with the psychology and management theories in connection with motivation and creativity within the context of directors' business decisions. To put it from another perspective, whether or not creativity, motivation and types of business decisions actually underpin the existing judicial or legislated deference. The finding is also necessary to contribute to the formulation of a mechanism on which types of business decisions (non-programmed creative; and programmed non-creative) can be clearly identified and measured by the judge in deciding the enforcement of derivative negligence claim by way of judicial and legislated deference.

COMPANY DIRECTORS' DUTY OF CARE – THE BACKGROUND

Section 174(2) of the Companies Act 2006 codified the common law doctrine by imposing a dual standard duty of care, skill and diligence.[35]

Prior to the enhancement of Companies Act 2006, there was an extensive discussion and debate regarding the proposed codification. The Company Law Review laid out the followings recommendations as grounds in support of codification:

> The case for and against providing a clear restatement of directors' duties has been examine by the Law Commissions and has been set out by us in Developing the Framework and Completing the Structure. We continue to recommend such a legislative statement. We do so for three main reasons:
>
> - It will provide a greater clarity on what is expected of directors and make the law more accessible. We believe that this will in turn help to improve standard of governance;
>
> - It will enable defects in the present law to be corrected in important areas where it no longer corresponds to accepted norm of modern business practice: this is particularly so in relation to the duties of conflicted directors and the power of the company in respect of such conflicts; and

[35] 'This codified common law duty as opposed to a fiduciary one' – see Sheikh, *Company Hand Book* (Bloomsbury Professional 2016) 549; Mayson and French and Ryan, *Company Law* (34th edn, OUP 2017-2018) 473; Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' (2011) ICCLR 22(2) 31-41

> It is in key element of addressing the question of 'scope' – i.e., in whose interest should companies be run – in a way which reflects modern business needs and wider expectations of reasonable business behaviour.
>
> The need for clear, accessible and authoritative guidance for directors on which they may safely rely, on the basis that it will bind the courts and thus be consistently applied, combined with the needs to clarify the law in the area of uncertainty and to make good the defects, make us all the more convinced that the case for a legislative restatement of directors' duties, or codification, is well founded.[36]

Kershaw has explained in a clearer perspective, the background of directors' duties and the reasons for codification of directors' duties into a one piece of legislation was a way to provide company directors (who are not normally legally trained to understand common law development) with a set of authority which clearly sets out the standard of conduct relating to duty of care (thereby avoiding ' … ambiguities and unsolved tensions between existing cases' [37]). It is also intended through modernisation of the law to resolve the common law problem in slowly adjusting itself to the change of business environment.[38]

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[36] 'The Modern Company: Internal Governance and External regulation' Company Law Review Steering Group: Final Report Chapter 3 as cited by Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 318

[37] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 317

[38] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 317

The legislator has seized the opportunity to codify the common law doctrine of directors' duty of care into statute. Thus, making sure that the modern law practice relating to directors' duty of care is being brought up-to-date with an attempt to eliminate any uncertainty or ambiguities surrounding the common law or equitable principles.[39] The problem as identified by Kershaw is that any problem of gaps and ambiguities relating to the common law or equity (both of which the 2006 Act relies for statutory interpretation), would persist and that the statute is not more than a re-statement of its underlying equity and common law legal principles.[40]

Despite Kershaw's criticism, Zwinge has pointed out that one clarification or certainty that the codification of 2006 Act has achieved in relation to directors' duty of care is to address the issue related to the standard of care expected from directors that was articulated in *Brazilian Rubber Plantation and Estate Ltd and re City Equitable Fire Insurance Co.* In other words, the question of whether the standard of conduct is to be based on objective standard or a dual standard based on both objectivity and subjectivity that had confused many for years is now put to rest by the codification.[41]

It follows that, the existing common law and equity principles have not been abolished by the 2006 Act. Rather, they are now the 'instruments' of which Section

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[39] See for example, Andrew Hick, 'Directors' Liabilities for Management Errors' (1994) 110 LQR 39, 391

[40] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 318

[41] Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' (2010) ICCLR 22(2) 31-41

174 can function. It is therefore, academically and legally essential to first understand how the common law and equitable principles developed and how they apply in order for one to properly grasp the true meaning behind directors' statutory duties of care.

COMMON LAW AND EQUITY PRINCIPLES

As mentioned above, due to the codification of the relevant common law and equitable principles re Companies Act 2006, it is essential to first understand how the relevant law developed and applied. I shall, therefore, in the following sections of this chapter, demonstrate how, through the development of common law, different types of business decisions have been identified by the courts in determining judicial deference. Precisely, the sections of the chapter will demonstrate how the law developed from being indistinguishing of all categories of business decisions, namely both business judgment and director's internal control & functional responsibilities[42] or directors' corporate governance functions,[43] by way of modest standard duty of care and skill to the separation of both types of business decisions.

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[42] i.e., monitoring and supervision or to acquire **the skills** that are reasonably expected to be relevant to the company's business. Examples of the relevant cases include *Overend Gurney & Co v. Gibb* [1872] LR 5 (HL) 580; *re Brazilian Rubber Plantation and Estates Ltd* [1911] 1 CH 425 (Ch); *Re City Equitable Fire Insurance Co* [1925] CH 707 (CA); *Dorchester Finance Co v Stebbing* [1989] BCLC 498 (Ch); *Norman v. Theodore Goddard* BCLC 1027 (Ch); and *Re Barings plc (No. 5)* [2000] BCLC 532 (Ch) which will all be relevantly discussed in the latter part of this chapter.

[43] See generally Keay A & Loughrey J, 'The Concept of Business Judgment' Legal Studies 1 < https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019

JUDICIAL DEFERENCE: MODEST STANDARD OF DUTY OF CARE AND SKILL

Traditionally, common law did not allow derivative action on directors' negligence (with the exception of fraud on minority shareholders of which I shall cover in greater detail in the part two of this chapter). Actions for negligence were taken against directors by company liquidator as a result. However, a closer examination of the negligence action cases might reveal an element of judicial deference. In this section, I shall demonstrate that this element of judicial deference may have been based on a subtler approach; and shows the reluctance of the judges to hold directors liable for negligence despite the relevant actions that were available against them. In other words, instead of applying a straightforward deference in a fashion as seen in Section 263 Companies Act 2006, a subtle deferential approach has been exercised within the legal expectation relating to directors' managerial decision-making. The importance of going through the common law legal history is needed, as eventually the common law principle relating to action of negligence against directors was codified into the Companies Act 2006 of which relevant lawsuit can now be generally available to shareholders by way of derivative claims. It is, therefore, essential to know whether or not elements of judicial deference is available in the relevant common law as ultimately the common law affects how a derivative claim is to be conducted against directors under the statute.

Traditionally, liability attached to directors' duties of care has been taken by the courts to be at its modest or minimum fashion.[44]

As pointed out by writers such as Hicks, Tomasic and Tamo that it was commonly believed that directors were traditionally protected by judicial deference for breach of duty unless such a duty constitutes gross negligence (*Overend Gurney & Co v. Gibb*[45]). This is because directors '…were treated as "trustees" or "quasi-trustees" who had "very few duties in common law at that time"'.[46] For instance, in the case of *Carlen v. Drury*, the court of equity said that

> … in order to obtain an inference a Case of Breach of Engagement, or Abuse of Trust, must be established to the **perfect Satisfaction** of the court; that persons will not according to their Duty attend to the 'Interest of the Concern' to give directors a wider scope of judicial deference in relation to their business decision- making power.[47] The court further states that … This court is not

[44] Nicholas Bourne, 'Directors -- Duty of Care and Skill' (2004) 25 Bus L Rev 218 as cited by Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' (2011) 22(2) ICCLR 31, 41; See also Grantham and Rickett, *Company and Securities Law (Commentary and Materials)* (Thomson Reuters 2001) 565

[45] [1872] LR 5 (HL) 580; and Tomasic, 'Corporate Rescue, Governance and Risk Taking in Northern Rock: Part 2' (2008) Comp Law 29(11), 333

[46] Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(2011)* 22(2) ICCLR 31, 41

[47] [1812] 1 V & B 154 (Ch) 158. Also cited by Grantham and Rickett, *Company and Securities Law (Commentary and Materials)* (Thomson Reuters 2001) 568; see also Moore on *Corporate Governance in the Shadow of the State* (*Hart Publishing* 2013)

> required on every occasion to take the Management of every playhouse and Brewhouse in the Kingdom.[48]

Similar approach was taken by the court in *Howard Smith Ltd v. Ampol Petroleum Ltd* who stated '…. there is no appeal on merits from management decisions to court of law; nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.' [49]

Again, these cases have established traces of judicial deference, i.e., unless directors were acting dishonestly or with gross negligence, the court will not interfere with the business judgment of directors.

As discussed in the previous section, action for negligence against company directors has only been traditionally available to and exercisable by liquidators in the insolvency proceedings of companies (See for instance, *Re City Equitable Fire Insurance Co*[50]). When an action for negligence was brought to the court (as we can see from the latter part of this Chapter), and notwithstanding the gradual judicial 'encroachment' on scope relating to directors' management responsibility and standard of conduct relating to duty of care, (the approach of judicial deference somehow finds its way into the modern law practice through the statutory provisions of Sections 263(2)(a), 263(3)(b) of Part 11 of the Companies Act 2006) with

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[48] ibid
[49] [1974] AC 832 (PC) [822], [832]
[50] [1925] CH 407 (CA)

traditional preclusion of gross negligence via the pre-conditions of good faith on the part of the directors. The interpretation of these pre-conditions continued to be "imported" through the common law, e.g., *Re D'Jan of London Ltd*.[51]

Now back to the traditional approach, as commented by Hicks 'according to traditional view, there is no general professional standard of expertise needed to directors.'[52]

A great degree of common law judicial deference was highlighted in *re Brazilian Rubber Plantations and Estates Ltd,*[53] where Nevill L J held that first, the directors were not grossly negligent by simply placing their trust and reliance on the judgment and information of

> … persons whom, it is said, they ought to have known to be interested. One of them Web (a leading London Solicitor at the time), was a person in position entitling his opinion and word to great weight, and though reflection would have shown the directors that he could not have been instructed to act on behalf of the company by persons independent of the promoters,[54] I think the directors were not to be blamed for placing considerable reliance upon his assurances [the directors were apparently not aware that the information provided by Webb

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[51] [1994] BCC 646 (Ch)

[52] Andrew Hicks, 'Directors' Liability for Management Errors' (1994) 110 LQR 390 as cited by Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) 22(2) ICCLR 31, 41; Sheikh, *Company Hand Book* (Bloomsbury Professional 2016) 549

[53] [1911] 1 CH 425 (Ch)

[54] (for the sale of the plantation)

> was based on information provided by the promoters of the syndicate] … upon the whole I came to the conclusion that the directors believed that the contract was a beneficial one for the company, and that, notwithstanding the discrepancy in prices and the absence of an independent report, this conclusion was not arrived by the negligence on their part as directors …[55]

As the issue of gross negligence was ruled out by the judge, the next question was whether or not the director was acting negligently.

It was further held by Neville J, in support of judicial deference, by simply ruling out duty of care to the company in certain situations all together:

> A director's duty has been laid down requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualifications to his office. He may undertake management of a rubber company in complete ignorance of anything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance.[56]

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[55] As cited by Kershaw, *Kershaw Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 421

[56] 1 CH 437 as cited by Mayson and French and Ryan, *Company Law* (34th edn, OUP 2017-2018) 495; Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP Oxford 2012) 420; see also Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) 22(2) ICCLR 31 - 41

Neville L J's judgment placed a modest burden of responsibility upon directors in terms of their skills relevant to the company's business. In other words, Neville L J's effectively meant that a person can act as a director of a company without any knowledge whatsoever about the company's business.

The essence of Neville J's judgment was that, as far as law was concerned, in *re Brazilian Rubber Plantation and Estates Ltd*, the scope of judicial deference was very wide as the standard of care was solely a subjective standard, In other words, and as Reed cites it, 'a director "could be" in complete ignorance'[57] of relevant knowledge of the company's business but if he has, then he shall be assessed in accordance with the expertise that he possessed.[58]

Neville J concluded that firstly, there is no obligation on the part of the directors to have any special qualification; and secondly, directors do not have any obligation to attend any company meeting or 'take any definite part in the conduct of the company's business.'[59]

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[57] 1 CH 425 (Ch) as cited by Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 171

[58] Mayson and French and Ryan, *Company Law* (34th edn, OUP 2017-2018) 495; see also See Andrew Hicks and S H Goo, *Cases and Material on Company Law* (6th edn, OUP 2008) 387; Also cited by Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) 22(2) ICCLR 31-41, 32

[59] See Grantham & Rickett, *Company and Securities Law, Commentary and Materials* (Thomson Reuters 2001) 565

To this end, the judges supported the ruling above by restating the 'intermittent principles' which had been first established in *Overend Gurney & Co v. Gibb*[60] and re-affirmed in *re Cardiff Savings Bank; the Re Marquis of Bute's Case*[61] that directors do not owe a duty to attend the company's meetings but if he does, then must exercise reasonable care.[62]

On the face of the case, Nevile J was only following the previous cases by requiring a modest standard of duty of care and skill owed by directors to their companies. However, to take a closer look at the case by drawing on the impact of the ruling on the liability of company director and the scope of action exercisable by insolvency liquidators, one can see that the judge applied a modest (subjective) standard of care as a way to refuse judicial intervention on actions against directors' negligence. This, ruling reflects a judicial deference that was achieved through the modest standard of care and skill expected from the director.

What was confusing here is that while Neville J imposed a subjective standard of care onto whether or not the expertise is possessed by the directors, but when it comes to the reasonable care exercised by directors who turns up at the meeting, he held that the reasonable care is to be assessed by what standard of care that 'an ordinary man

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[60] [1872] LR 5 (HL) 580

[61] [1892] CH 100 (Ch) 3

[62] Dignam & Lowry, Company Law (8th edn, OUP 2014) 359; Sheikh, *Company Hand Book* (Bloomsbury Professional 2016) 549; Grantham & Rickett, *Company and Securities Law, Commentary and Materials* (Thomson Reuters 2001) 566-567

might be expected to take in the same circumstances on his own behalf.'[63] As I shall demonstrate in the immediate following that this would later be used by both Kershaw and Hick to argue that the standard of care imposed by Neville J was not purely subjective, rather, it was a dual standard. And in the context of this Chapter would have a different impact to the extent of or even the existence of judicial deference in the process of action for negligence, or by the standard of post- Companies Act 2006 – Derivative claims.

This brings it nicely to the immediate following, where judicial deference through modest and subjective standard of care and skill was arguably continued to be applied by Romer J in *Re City Equitable Fire Insurance Co*[64]. However, the certainty of judicial deference was dimed by the two schools of thoughts amongst modern scholars in connection with what standard of care was actually required by the judge. Much would depend on which school of thoughts is correct in determining the existence of or the extent of the judicial deference.

In *Re City Equitable Fire Insurance Co*[65] a case which was widely cited as a leading case in directors' duty of care prior to the 1990s, Romer J took a cumulative approach on the traditional common law principles including principles laid down in both *re*

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[63] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 421

[64] [1925] CH 407 (CA); also as cited by Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' (2011) 22(2) ICCLR 31, 32

[65] ibid

Cardiff Savings Bank or *the Re Marquis of Bute's Case*[66] and *re Brazilian Rubber Plantations and Estates Ltd*[67]introducing three propositions as follows:

> … (1) A director need not exhibit greater skill than can be expected of a person of his or her knowledge and experience. (2) A director is not bound to give continuous attention to the affairs of his company. His duties are of intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however bound to attend all such meetings, though he ought to attend whenever, in the circumstance, he is reasonably able to do. (3) in respect of all duties that, having regard to the exigencies of the business, and the articles of association, may properly be left to some other official, a director is, in the absence of ground of suspicion, justified in trusting that official to perform such duties honestly.[68]

Adopting the same standard of subjective standard of care (proposition 1) as established in *re Brazilian Rubber Plantations and Estates Ltd*[69]*,* Romer J attributes his position to Lord Hatherley LC's judgment in *Overend Gurney & Co v. Gibb*[70]*:*

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[66] [1892] CH 100 (CA)
[67] [1911] 1 CH 425 (Ch)
[68] [1925] CH 407 (CA); also as cited by Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) 22(2) ICCLR 31, 32; see also Dignam & Lowry, *Company Law* (8th edn, OUP 2014) 359-360
[69] Mayson and French and Ryan, *Company Law* (34th end, OUP 2017-2018) 494; Sheikh, *Company Hand Book* (Bloomsbury Professional 2016) 549
[70] [1872] LR 5 (HL) 480, 494 - 495

> ... I think it would be a very fatal error in the verdict of any Court of Justice to attempt to measure – the amount of prudence that ought to be exercised by the amount of prudence which the judge himself might think, under similar circumstances, he should have exercised. I think it extremely unlikely that many a judge, or many a person versed by long experience in the affair of mankind, as conducted in the mercantile world, will know that there is a great deal more trust, a great deal more speculation, and a great deal more readiness to confide in the probabilities of things, with regard to success in mercantile transactions, than there is on the part of those habits of life are entirely of a different character.

Sheikh has also suggested that standard of duty of care imposed by the court in this case was a low standard as it was purely based on a subjective test.[71] Looking from a different perspective, Farer, however, has suggested that despite the rather relaxed standard in Romer J's judgment from the modern perspective, the standard nevertheless represent 'a tightening of the existing law at the time'.[72] In other words, the scope of judicial deference could be said to be better defined by way of Romer J's cumulative approach. But what we can see here was that the distinction between the

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[71] Sheikh, *Company Hand Book* (Bloomsbury Professional 2016) 549

[72] Farrar, *Corporate Governance: Theories, Principles and Practice* (3rd edn, South Melbourne: OUP 2008), 138 as cited by Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' (2011) ICCLR 22(2) 31, 32

functional & internal control responsibilities and the business judgment was still not clearly separated for the purpose of judicial deference.

If the academic writers such as Farer's, Mayson et al, and Sheikh' s interpretation of the Romer J's decision was correct, we can then see a continuation of an element of judicial deference by way of modest standard of care as proposed to that articulated by Neville J *on Brazilian Plantation case*. The extent of the duty of care was **subjective** with the approach that as long as the directors were acting in good faith with his belief that the business decision was made in the interest of the company, the court shall be deferential to the action. Romer J at the same time, re-iterated the judgment laid down in *Overend Gurney & Co v. Gibb*[73] indicating judicial deference in favour of another type of business decision that is speculative and unbound by any predefined rules, i.e., business judgment.[74] This judicial approach shows a respect and recognition from the court towards business judgment of directors that there can be no assumption of the right business decision upon the board, as per Romer J citing *Lagunas Nitrate Co v. Lagunas Syndicate*[75], 'It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgment.'[76] The judicial approach to avoid second guessing the business judgment of the director remained the law in the eyes of the judges in subsequent cases such as *Shuttleworth v*

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[73] [1872] LR 5 (HL) 480, 494-495
[74] *Re City Equitable Fire Insurance Co* [1925] CH 707 (CA) 77-78
[75] [1899] 2 CH 392 (CA) 435
[76] [1899] 2 CH 407 (CA) 429

Cox Bros & Co[77] (adopting the bona fide test laid down in *Sidebottom v. Kershaw, Leese and Company Limited*[78] and *Howard Smith Ltd v. Ampol Petroleum Ltd.*[79]

To support the courts' traditional deferential approach in the issue of business judgment as discussed above, Reed has referred to director disqualification cases to show that 'the courts have declined to find unfitness on the basis of what has turned out to be commercial judgment (except in the case of gross negligence) in the substance of a business decision.' – *Re Lo-Line Electric Motors*[80]; & *Re McNulty's Interchange.*[81]

[77] [1927] 2 KB 9 (CA)
[78] [1990] 2 KB 9 (Ch) 18-20
[79] [1974] AC 821 (PC)
[80] [1988] CH 477, (Ch) 486 as cited by Reed, 'Company Directors – Collective or Functional Responsibility' Com Law 171
[81] [1989] BCLC 712 (Ch) cited by Reed, 'Company Directors – Collective or Functional Responsibility' Com Law 171

In reaching the judgment, Foster J accepted the company plaintiff's submission made against the directors in regard to their breach of duties of care relating to the issues of oversight was CORRECTLY made. And the submission as made as follows:

> … a) A director is required to exhibit in performance of his duties such a degree of skill as may reasonably be expected from a person with his knowledge and experience. b) A director is required to take in performance of his duties such care as an ordinary man might be expected to take on his behalf. C) A director must exercise any power vested in him, as such honesty, in good faith and in the interest of the company and reliance was placed *on re City Equitable Fire Insurance Co Ltd* [83]… and *re Smith & Fawcett ltd* [84] …[85]

Consequently, Foster J held all the directors were liable for negligence and damages were awarded against them.

The court this time held the directors liable to compensate the loss of the company without the finding of gross negligence.[86] This is a deviation of the traditional view that liability was strictly based on gross negligence.

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[82] BCLC 498 (Ch)
[83] [1925] CH 407
[84] [1942] CH 304
[85] Ibid 83
[86] Grantham & Rickett, *Company and Securities Law, Commentary and Materials* (Thomson Reuter 2001) 563; Griffin, *Company Law Fundamental Principles* (4th, edn, Longman 2005) 312

Foster J's acceptance of the plaintiff company's submission above represent a ground-breaking development relating to the issues of internal control and oversight (in this case, the directors' failure to supervise another). In the interpretation of the interaction of the objective test based on the standard of an ordinary person and subjective standard test based on the level of a director's actual skill, knowledge and experience i.e., a subjective test will only be applied when the directors possess and took certain knowledge, skill and experience into his office. For instance, an accountant as shown in the *Dorchester* case. However, there is no defense against an action for breach of duty of care and skill for the director who does not possess any special skill, as he would still be judged objectively against the baseline, i.e., the standard of an ordinary person.[87]

Another interesting fact in this case as pointed out by Hick and Kershaw was, despite Foster J's apparent taking of a segregated approach relating to skill and care; it was a case law development towards the direction of the segregation of the two duties. Once again, and like his predecessor, Foster J used the terms skill and care interchangeably.[88]

Where *Dorchester* departed from *Brazilian Plantations* was that the court was no longer prepared to accept the director's defense that he does not owe a duty of care to

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[87] See Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) 22(2) ICCLR 31, 32

[88] Hick, 'Directors' Liabilities for Management Errors' (1994) 110 LQR 390, 391; and Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 428

the company that he serves on the basis of his absence in the relevant company board meetings. In other words, the court took a more stringent approach with the interpretation that being attentive to the affairs of the company's business is now part of the internal control or supervision. Therefore, a requirement to satisfy the objective test of an ordinary man. This judicial approach was adopted in a number of subsequent cases, such as *Re Westmid Packing Services Ltd;* and *re Baring Plc and Others (No. 5)*.[89] In complying with the objective standard of duty of care, as pointed out by Hannigan, an executive director would have a general duty 'to oversee the activities of the company', including a duty to properly sign cheques.[90] This view while, generalising the legal position laid down by Foster J, is not however, strictly accurate. As Foster J's decision on directors under a duty to exercise a general duty to oversee the activities of the company was also directed to both non-executive directors, namely, Hamilton and Parson (having taking into account the accountancy background of the three directors of course).[91] Foster J commented:

> For a chartered accountant and an experienced accountant to put forward the proposition that a non-executive director has no duties to perform I find quite alarming … the signing of blank cheques by Hamilton and Parsons was in my judgment negligent, as it allows Stebbing to do as he pleased. Apart from that

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[89] [1998] 2 ER 124 (CA) and [1999] 1 BLCL 433 (Ch) respectively. Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 428; Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) 22(2) ICCLR 31, 32

[90] Hannigan, *Company Law* (4th edn, OUP 2015) 245

[91] Grantham & Rickett, *Company and Securities Law, Commentary and Materials* (Thomson Reuters, 2001) 563; Farrar, *Farrar's Company Law* (4th edn, Butterworths Law 1998) 393

> they not only failed to exhibit the necessary skill and care in the performance of their duties as directors, but also failed to perform any duty at all as directors of Dorchester.[92]

Going back to the fundamental issue of the historical development of judicial deference relating to the issue of internal control or oversight, we are seeing a gradual separation of the types of directors' business decisions by filtering out directors' function & internal control responsibilities from business judgments for the purpose of judicial deference. This is so, not just as a result of the court's confirmation of assessing the directors' duty by way of dual standard test. But Foster J's clarification on what is expected from a reasonable person now covers directors' duty to be actively attentive to the company's affairs. We also see that in the subsequent cases the court continued to adopt this stringent approach through an expectation that a reasonable man's standard of being attentive to the company's affair is not limited to a duty to attend the company's meetings as specifically dealt with by Neville J in *Briazillain Plantation* Case, but also extents to a wider scope of duty to oversee the activities of the company. Once again, this shows a strong resemblance to the American business judgment rule whereby the decision of the directors complained is

[92] *Dorchester Finance v. Stebbing* [1989] BCLC 498 (Ch) 505 8

the type of decision refers to matters of inattention or oversight, then the defense of business judgment rule will not be available (*Deal v. Johnson*).[93]

[93] [Ala.1978] So. 2d 214, 362. Also cited by Arsht, 'The Business Judgment Rule Revisited' (1979-1980) 8 Hofstra L Rev 112

SUMMARY

The historical development and gradual change of judicial deference in the process of negligence lawsuits relating to the issues of oversights and internal control in pre-1990s common law can be broadly divided into three stages. First, the existence of judicial deference reflected through the judicial imposition of the modest standard of care and skill. Standard of conduct was strictly based on subjective test with directors having no active duty to possess any relevant expertise or knowledge relating to the company's business. In addition, no objective test could be generally imposed in the assessment relating to the issue of breach of duty which resulted in a wide scope of judicial deference in a number of areas including the strict application of the intermittent principles as established in *Overend Gurney & Co v. Gibbs*[94] and shown in *re Brazilian Rubber Plantations and Estates Ltd.*[95]

This wide scope of judicial deference was arguably followed by Romer J in his famous three propositions in *re City Equitable Fire Insurance Co.*[96] In *Dorchester Finance v. Stebbing,*[97] the court had the opportunity to confirm the requirement of the dual standard of care as a mechanism in assessing directors' breach of duty relating to the issue of internal control and supervision. This included the active roles of directors in overseeing the activities of the company as a whole.

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[94] [1872] LR 5 (HL) 480
[95] [1911] 1 CH 425 (Ch)
[96] [1872] CH 407 (CA)
[97] [1989] BCLC 598 (Ch)

Despite the stringent judicial approach adopted by the court in *Dorchester Finance* case relating to the issue of supervision and oversight, the courts continue to adopt a broad deferential approach to the issues relating to business judgments. I shall demonstrate in the latter part of this chapter that such a deferential approach remains a focused commonplace in the shareholders' enforcement stage of director's duties under Part 11 of the Companies Act 2006.

In conclusion, this chapter has demonstrated the existence of a wide scope of judicial deference within the common law by way of the imposition of the modest duty in the matter relating to directors' business judgment. It has also demonstrated a gradual encroachment of directors' right to deference relating to directors' duty of internal control (as opposed to business judgment) to a point of near obliteration which took place with the clear imposition of the dual standard of care.

JUDICIAL DEFERENCE: BUSINESS JUDGMENT VS FUNCTIONAL RESPONSIBILIY & INTERNAL CONTROL

NORMAN V. THEODORE GODDARD [1991][98]

As the court felt that the standard adopted in the cases prior to 1990s was too low as a standard, this case represents the first case where the court drew a link between the common law and the statute and took the view that the dual standard duty

[98] BCLC 1027 (Ch)

of care to possess the required business skills in common law was set out in Section 214(4) of Insolvency Act 1986.[99]

Section 214(4) states:

> … the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both—
>
> (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
>
> (b) the general knowledge, skill and experience that that director has.

This approach is more stringent than all the previous common law approaches mentioned above as section uses the words, 'ought to'. By relying on Section 214(4) of Insolvency Act, Hoffman J, 'concluded that the relevant test of a directors' duty is not merely a subjective test … he pronounced an objective requirement that the director must possess the skill "that may reasonably be expected from a person undertaking those duties."' Adding by way of an example, 'a director who undertakes

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[99] See Bird et al, *Boyle & Bird's Company Law* (9th edn, Jordan Publishing Limited 2014) 612-613; Mayson and French and Ryan, *Company Law* (34th edn, OUP 2017-2018) 495; Sheikh, *Company Hand Book* (Bloomsbury Professional 2016) 549; Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) 22(2) ICCLR 31, 32; Dignam & Lowry, *Company Law* (8th edn, OUP 2014) 361

the management of the company's properties is expected to have reasonable skill in property management, but not in offshore tax avoidance.'[100] Indeed, the court this time further identified the difference between business judgment and directors' functional responsibilities for the purpose of judicial deference by pushing an objective obligation onto directors' 'functional responsibility'[101], i.e., to acquire **the skills** that are reasonably expected to be relevant to the company's business.[102] This represents an expansion of the objective duty relating to the issue of internal control that directors need to be attentive to the company affairs laid down in *Dorchester Finance v. Stebbing.*[103] In that it creates a bridge linking the objective duty to the subjective duty. In other words, the objective standard first creates a duty to acquire the relevant skill, once this is satisfied, the court will move on to the subjective test in determining the director's compliance of the standard of the expertise required. The result of this "bridging process" would almost guarantee directors to be examined through both objective and subjective standard and place them under an inevitable greater burden to defend an action of negligence.

It is of little surprise that the court's decision to adopt Section 214(4) Insolvency Act 1986 for the interpretation of dual standard of care. This is because prior to

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[100] [1992] BCC 14 (Ch), 15; also cited by Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) 22(2) ICCLR 31, 32; Edmond & Lowry, 'The Continuing Value of Belief for Directors' Breach of Duty' (2003) MLO 210

[101] A term given by Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 172

[102] Mwaura, 'Company Directors' Duty of Skills and Care: A Need for Reform.' (2003) Com Law 285

[103] [1989] BCLC 498 (Ch)

Companies Act 2006, judicial deference was generally available to protect company directors (who have acted in good faith and derived no personal benefit through his majority shares from the transaction) from derivative actions (except in the case of fraud on minority shareholders), with the exception to claims launched by liquidators in the event of companies' insolvency (see for instance, *Daniels v. Daniels*[104] and *Barrett v. Duckett*[105]). This judicial move can therefore, be seen as a way to standardise the interpretation of dual standard of test in line with deferential environment within the realm of derivative actions at the time, with the consequence of a clearer difference between duty of care (care relating to the issue of internal control; and issues relating to business judgment) and skills (duty to possess the skills to undertake the management of the company); and for the purpose of judicial deference, a clearer difference between types of business decisions, namely, business judgment and responsibilities relating to directors' internal control and functions or corporate governance functions.

RE D'JAN OF LONDON LTD [1994]

Hoffman J held Mr D'Jan, the director liable for negligence on the ground that he had failed to read the insurance form before signing it. Like *Dorchester Finance v.*

[104] [1978] CH 406 (Ch)
[105] [1995] 1 BCLC 243 (CA)

Stebbing,[106] the court imposed liability upon the director without having the finding of gross negligence on the directors' part.

As Hoffman L.J. says, 'His breach of duty in failing to read the form before signing was not gross. It was a kind of thing which could happen to any busy man. Although as I have said, this is not enough to excuse it.'[107]

In giving the judgment, Hoffman J, reaffirmed his view expressed in *Norman v. Theodore Goddard*[108] that company directors' duty of skill at common law was correctly reflected in the dual standard of skill in Section 214 Insolvency Act 1986).[109] As per In Hoffman L.J. *Re D'Jan of London*[110] 'in my view, the duty of care owed by a director at common law is accurately stated in section 214(4) of the Insolvency Act 1986 … Both on the objective and subjective test …'

No reference, however, was made by Hoffman J as to how he came out with this interrelation between the common law duty of care and Section 214. But without

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[106] [1989] BCLC 498 (Ch)

[107] *Re D'Jan of London Ltd* [1993] BCC 464 (Ch) 450 See also Gerner-Beurle and Edmunf-Phillipp Schuster, 'The Evolving Structure of Directors' Duties in Europe' (2014) 15, EBO LR 191, 202

[108] [1990] BCC 14 (Ch)

[109] Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) 22(2) ICCLR 31, 32; Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 431

[110] [1993] BCC 646 (Ch) 648

further investigation into the authority of Hoffman J's interpretation, subsequent case law adopted this approach.[111]

One thing for sure, however, is that the traditional judicial deference by modest standard of care during the process of negligence action at this stage of the common law development can be said to be completely and practically filtered out through the 'bridging process' of the dual standard test as discussed in *Norman v. Theodore Goddard* above.

RE BARING PLC (NO. 5) [2000]

This is the case where the court placed a great emphasis on the responsibility of company directors relating to the matter of internal control, i.e., directors' corporate function to delegate, followed up with the duty of supervision; and duty to possess management skill. It is in this area where we see a great departure from the pre-1990s common law rulings such as *Re Brazilian Rubber Plantations and Estate Ltd*[112]; and *Re City Equitable Fire Insurance Co*[113] where the intermittent principles and the trust principle under Romer J's three proportions represented the center of judicial deference by way of modest standard of care and skill.

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[111] As pointed out by Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 431; Dignam & Lowry, Company Law (8th edn, OUP 2014) 359; Sheikh, *Company Hand Book* (Bloomsbury Professional 2016) 396

[112] [1911] CH 1 425 (Ch)

[113] [1925] CH 407 (CA)

In this case Jonathan Parker J referred to the ruling in *Daniels v. Anderson*[114] and held that the extent of the directors' duty relating to supervision would vary depending on 'the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to office.'[115]

The tightening of directors' duty to supervise was affirmed by Langley J in the subsequent case – *Equitable Life Assurance Society v. Bowley*[116] and in turn, rejected Romer J's propositions in *Re City Equitable Fire Insurance Co*:

> In respect of all duties, having regard to the exigencies of the business, and the articles of association, may properly be left to some other official, a director is in the absence of ground for suspicion, justified in trusting that official to perform such duty honestly.[117]

Landley J further commented that 'I do not think this statement does represent the modern law … at least if it means unquestioning reliance upon others to do their job'[118]

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[114] [1995] 16 ASCR 607, 666 cited by Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 173

[115] Re Barings plc [1999] BCLC 433 (Ch) 488. See also Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 173

[116] [2003] BCC 829 (QB)

[117] [1925] 1 CH 407, 427-230 as cited by Langley J in *Equitable Life Assurance Society v. Bowley* [2003] EWHC 2263, (QB) [40]

[118] ibid [41]

With regards to directors' duty to possess the necessary management skill, Jonathan J went one step further than *Norman v. Theodore Goddard*[119] that not just directors need to possess the skill to manage the company, but they have 'both collectively, and individually, a **continuing** duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors'.[120] Therefore, the duty of skill is a continuing process requiring directors to constantly update their knowledge of the company's business.

It should be noted that Keay and Loughrey have argued that the 'courts' position is ambivalent',[121] as in *ARB International Ltd v. Baillie*[122], the court held that the director could take a 'practical view'[123] by delegation of tasks to his subordinate as far as the director first making sure with his subordinate have access to the him for advice or guidance when needed.[124] This approach, as Keay and Loughrey suggested, regarded the director's decision-making process 'as matters of judgment'[125].

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[119] [1991] BCLC 1027 (Ch)

[120] Re Barings plc (No. 5) [2000] BCLC 532 (Ch) [535], [536] as cited by Mayson and French and Ryan, *Company Law* (23rd edn, OUP 2006-2007) 557

[121] Keay A & Loughrey J, 'The Concept of Business Judgment' Legal Studies 1, 11 < https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019

[122] [2013] 2 CLC 255 (QB)

[123] Keay A & Loughrey J, 'The Concept of Business Judgment' Legal Studies 1, 11 < https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019

[124] *ARB International Ltd v. Baillie* [2013] 2 CLC (QB) 268

[125] ibid 255

As mentioned above, the ambivalence of the courts' position does or does appear to exist, however, if we were to take the director's entitlement to delegate in *ARB International Ltd v. Baillie* as a business judgment, it is possible, from a perspective of the theory of types of business decisions (as focused in Chapter Four), to argue that the director's level of supervision based on his assessment of his staff's situation represents a type of business decision within another. In other words, the directors' decision to delegate based on the proper assessment for his subordinate to 'seek his advice if they had question' represents a Non-Programmed (Creative) Business Decision[126] (as long as the decision of which the assessment was based was ill-defined) within the general duty of monitoring and supervision (a programmed business decisions).

On the other hand, if the director's decision fails to satisfy the condition of a Non-Programmed (Creative) Business Decisions, one might argue that the court's position in *ARB International Ltd v. Baillie* did not treat the director's decision to delegate as a business judgment (in other words, the term 'business judgment' was wrongly used by the court to describe the corporate governance functions of the director), but part of the fulfillment of the director's monitoring and supervision decision. This is because, as opposed to the directors in Re Baring (No. 5), the

[126] A Non-Programmed (Creative) Business Decision is a term coined by this thesis to describe, from a psychology perspective, a business judgment. In order for a business decision to constitute a Non-Programmed (Creative) Business Decision, a number of specific psychology conditions need to be satisfied. The full specification regarding the conditions establishing this type of business decision is fully described in Chapters Four and Five. This type of business decision represents the core of the research of this thesis.

director in *ARB International Ltd v. Baillie* had kept himself informed of the company's business and undertaken assessment on his staff's need to seek his advice. And as held by the court that the director 'had adequately supervised the delegated functions.'[127]

SUMMARY

The post 1990s common law development of the negligence action relating to the issue of internal control, oversight and continuing duty to acquire the necessary management and business skill has been shaped towards the building of a more vigorous standard of care. The dual standard represents the official benchmark upon which company directors would be assessed. This in effect creates a 'bridging process' between the objective test and the subjective test, leading to the extinction of judicial deference based on the modest standard of care and skill founded in pre-1990s common law cases.

However, the tightening of the standard does not appear to have applied to the matters of business judgment as we can see in the enforcement stage mentioned below. In other words, the law started to set a clearer distinction between and directors' responsibility relating to the matter of internal control, i.e., function to delegate followed up with the duty of supervision; duty to possess management skill; and

[127] Ibid 256

business judgment with the latter type of decision (business judgment) being protected by judicial deference.

JUDICIAL DEFERENCE ON DIRECTORS' BUSINESS JUDGMENTS (ENFORCEMENT STAGE)

THE POSITION PRIOR TO THE COMPANIES ACT 2006

A business judgment can be described as a business decision that is not bound by any predefined rule and deals mainly with 'a great deal of speculations'[128] and the decision maker needs to have a 'great deal more readiness to confide in the probabilities of things'.[129] As opposed to dealing with directors' responsibilities relating to internal control or their functions as mentioned in the above section, this section will discuss the deferential approach applied by the courts insulating directors from liability for their decisions made within the context of business judgment. This section will demonstrate that provided the business decision/judgment was made by the directors in good faith, and acting as an appropriate independent organ of the company, the directors would historically be protected. From this perspective, the stage of enforcing company directors' duty of care within the context of this research represents the crucial stage, whereby judicial deference can be clearly traced. Judicial deference at the enforcement stage is pre-dominantly found within the two main timelines, namely the legal position prior to Companies Act 2006 and the legal

[128] *Overend Gurney & Co v. Gibb* [1872] LR 5 [HL] 480
[129] ibid

position post-Companies Act 2006. The following will demonstrate that different scopes of judicial deference exist within each of these periods.

The concept of judicial deference has historically been closely linked to the concept of derivative action. In order to understand the concept of derivative action, one has to start the discussion from the basics as laid down below:

When it comes to legal enforcement of company directors' duties, traditionally, under the common law, only the company itself, not the shareholders, can do so. And since the board of directors is empowered to manage the company under the articles of association, they would be seeking the relief on behalf of the company.

This is rule famously laid down in the case of *Foss v. Harbottle*[130] also known as 'the proper plaintiff rule' as subsequently described by the judge in *Prudential Assurance Co Ltd v. Newman Industries Ltd (No.2)*[131] :

> … The Court of Appeal explained the effect of the rule when it stated that A is not usually able to take action against B in order to recover damage or relief on

[130] [1843] 2 Hare 461, 489 where the court held that the wrong doe by the promoter of the company to the company, the action against the promoter was allowed to be taken by the company as a separate person, not its members. See generally Finch, 'Company Directors: Who Cares About Skill and Care?' (1992) The Mod L Rev; Andrew Keay, 'Application to Continue Derivative Proceedings on behalf of Companies and the Hypothetical Director Test' (2015) CJQ 346-365, 346, 2; Kershaw, 'The Rule in Foss v. Harbottle is dead: Long Live the Rule in Foss v. Harbottle' (2015) JBL 2-26, 2; 'Editorial – A Statutory Derivative Action' (2007) Co Law 2-7, 2

[131] [1982] CH 204 (Ch)

behalf of C, when B has acted in such a way as to injure C. Sometimes this is known as the proper plaintiff rule.[132]

As pointed out by Tang that the proper plaintiff rule is closely connected to the doctrine of companies being separate legal entity (originally stated under section 18 Companies Act 1862 and later specified in the case of *Salomon v Salomon & Co Ltd*[133]), '… that once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself …'[134]

As frequently mentioned by academic writers such as Wedderburn[135] that as companies being separate legal entities, the courts have historically been reluctant to interfere with company directors' business judgment. This is because the judges took the attitude that, 'it is not the business of the court to manage the affairs of the company. That is for the shareholders and the directors.' - Per Scrutton L.J., *Shuttleworth v. Cox Bros & Co (Maindenhead) Ltd.*[136] The article*, 'Editorial – A Statutory Derivative Action'* (2007) explained the justification for the proper plaintiff rule was to limit the number of litigations 'than the interest of the company requires.'

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[132] See Andrew Keay, 'Application to Continue Derivative Proceedings on behalf of Companies and the Hypothetical Director Test' (2015) CJQ 346-365, 347; Armour et al, 'Private enforcement of corporate law: an empirical comparison of the United Kingdom and the United States' (2009) JELS 694

[133] [1897] AC 22 (HL). See also Tang, 'Shareholders' Remedies: Demise of the Derivative Claim?' (2012) UCL 178

[134] Ibid [30]

[135] Wedderburn, 'Shareholders' Rights and the Rule in *Foss v. Harbottle*' (1957) CLJ 194

[136] [1927] 2 KB 9 (CA) 23 as cited by Wedderburn, 'Shareholders' Rights and the Rule in *Foss v. Harbottle*' (1957) CLJ 194

[137] Plus the traditional courts' diffidence to 'interfere with the internal management of the company'[138] from the hindsight. This is known as 'the majority rule' as stated by the judge in *Carlen v. Drury* (1812)[139] that 'This Court is not to be required on every occasion to take the management of every playhouse and brewhouse in the Kingdom.' In subsequent cases such as *Burland v. Earle*, the court continues to show its diffidence in interfering with directors' business decision/judgment, as per Lord Davey: 'It is an elementary principle of the law relating to joint stock companies that the Court will not interfere with the internal management of the company acting within their powers, and in fact has no jurisdiction to do so.'[140]

However, with the acknowledgement of the courts dated back to the nineteenth century regarding the impracticalities involving directors taking legal action against their fellow director within the same organization. For instance, as given by Keay, 'if directors who were in breach of their duties or were associated with those who had wronged the company controlled the board then no action would be instituted',[141] the courts, allowed (as an exception to the proper plaintiff rule) shareholders to take derivative action on the company's behalf against directors. In other words, 'it is that

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[137] Barry Rider, 'Editorial – A Statutory Derivative Action' (2007) Co Law 2-7, 2
[138] Barry Rider, 'Editorial – A Statutory Derivative Action' (2007) Co Law 2-7, 2
[139] 1 Ves & B jr 10 as cited by Barry Rider 'Editorial – A Statutory Derivative Action' (2007) Co Law 2-7, 2
[140] [1902] AC 83 (PC) 93
[141] Andrew Keay, 'Application to Continue Derivative Proceedings on behalf of Companies and the Hypothetical Director Test' (2015) CJQ 2-19, 3

companies' money can only be properly expended for companies' purpose. It cannot be expended for personal purposes of directors or of shareholders ...'[142]

According to Keay, the term 'derivative action' was first used by the Court of Appeal in *Wallersteiner v. Moir (No. 2);*[143] and It is a legal concept borrowed from the American jurisdiction - *Meyer v. Fleming*.[144] This view is also supported by Mayson et al.[145] As was the purpose of derivative action, it is described as 'The purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interest of the corporation from the misfeasance and malfeasance of 'faithless directors and mangers' - *Cohen v. Beneficial Indus. Loan Corp.*[146]Indeed, as pointed out by Reisberg, that essentially, the court is imposing judicial control over the how derivative actions are to be carried out due to the purpose of ensuring the Rule of *Foss v. Harbottle*, i.e., that the action was brought in the interest of the company through its organs (through the general meeting of shareholders and the board of directors) as opposed to that of an individual shareholders. In other words,

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[142] Per Judge Norris in *Singh v. Anand* [2007] EWHC 3346 CH 11 -12 as cited by Lightman, 'The Role of the Company at the Permission Stage in the Statutory Derivative Claim' (2011) CJQ 1-9, 2

[143] [1975] QB 373 (CA)

[144] 27 U.S. 161, 167 [1946] See also Andrew Keay, 'Application to Continue Derivative Proceedings on behalf of Companies and the Hypothetical Director Test' (2015) CJQ 346-365, 347

[145] Mayson and French and Ryan, *Company Law* (34th edn, OUP 2017-2018) 555

[146]337 U.S. 541, 548 [1949] as cited by Aronsen et al, 'United States: Shareholders Derivative actions: From Cradle to Cradle' (2010) http://www.mondaq.com/unitedstates/x/87654/Directors+Officers/Shareholder+Derivative+Actions+From+Cradle+To+Grave> Last access June 2016; See also the similar definition in Palmer's Company Law (25th edn, Sweet & Maxwell) 803 as cited by Cabrelli, 'Derivative Actions: Part of Minority Shareholders' "Forensic Arsenal" in Scotland' (2003) SLT 73, 74

'… the individual shareholder is not enforcing the right which belong to him, but which rather vested in and therefore derived from the company.'[147]

Despite the opportunity for shareholders to bring a derivative action against the directors through the exception to the proper plaintiff rule; directors still enjoyed a wide scope of judicial deference against shareholders' derivative claim. This is so, as the decision to sue rested upon the company itself; and a dissatisfied member of the company was expected by law to accept the company's constitution dictating who had the power to decide on litigation or ratification. Normally these people were the directors; and the courts traditionally diffidence to replace its view to that of the business judgment of the directors[148] (*John Shaw and Sons (Salford) Ltd v. Shaw*[149]). On this basis, the exception to the proper plaintiff rule was based on the so called, 'the rule of wrongdoers' control' or more precisely, 'fraud on minority shareholders'. As pointed out by academic writers such as Reisberg and Armour, it was deemed to be a fraud, as essentially, it refered to the situation where majority shareholders were '… endeavouring directly or indirectly to appropriate to themselves money, property or advantages which belong to the company or in which other shareholders were entitled to participate.'[150] Or '… benefiting at the company's expense.'[151] In other words, the

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[147] Reisberg, *'Judicial Control of Derivative Action'* (2005) ICCLR 338

[148] Mayson and French and Ryan, *Company Law* (34th edn, OUP 2017-2018) 555-556

[149] [1935] 2 KB 113 (CA) also has been cited by Mayson and French and Ryan, *Company Law* (34th edn, OUP 2017-2018) 466.

[150] Reisberg, 'Shareholders' Remedies: The Choice of Objectives and the Social Meaning of Derivative Actions' (2005) EBOR 242

[151] Armour et al, 'Private enforcement of corporate law: an empirical comparison of the United Kingdom and the United States' (2009) JELS 694

power to litigate normally lied with the directors of the company[152] (save for the event where the company is in an insolvent proceeding). In *Burland v. Earle*, Lord Davey said:

> But an exception is made to the second rule,[153] where the person against who the relief is sought themselves hold and control the majority of the shares in the company, and will not permit an action to be sought in the name of the company. This is, however, a mere matter of procedure in order to give remedy for a wrong which would otherwise escape redress.[154]

Mayson et al, proposed that the last sentence of Lord Davey indirectly indicated that the court would not allow derivative action if the decision of the directors not to sue was taken in good faith and in the interest of the company. This assertion is supported by the common law rule in subsequent cases (*Taylor v National Union of Mineworkers (Derbyshire Area)* [155]).

Because the company would only act in its benefits, in the case of *Smith v Croft (No. 2),*[156] the court shown its diffidence to interfere with the managerial decision of the board through its expressive respect of the corporate will of the company undertaken

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[152] Table A, Article 70
[153] Proper claimant rule
[154] [1902] AC 83 (PC) 93
[155] [1985] BCLC 237 (HC) 255 respectively cited by Mayson and French and Ryan, *Company Law* (23rd edn, OUP 2006-2007), 664
[156] [1988] CH 114 (Ch) 6

'by an appropriate independent organ'.[157] As a result, the permission to continue the derivative action was not allowed. Knox J expressed his refusal to second-guess the directors' business decision/judgment, on the basis that the appropriate independent organ's decision not to continue the claim was made in the interest of the company; and Knox J's decision was made with a reference to the judgment in *Allen v. Gold Reefs of West Africa Ltd*[158] whereby the decision made by an appropriate organ on behalf of the company '… must be exercised, not only in the manner required by the law, but also bona fide for the benefit of the company.'[159] With further reference to other similar cases – *Brown v. British Abrasive Wheel Co. Ltd*[160] *and Sidebottom v. Kershaw, Leese & Co Ltd*,[161] Knox J concluded the court is diffident to 'substitute its own opinion' over the business judgment of the director as an appropriate independent organ. Therefore, the decision by the appropriate organ of the company not to continue the action against the director will be upheld, as long as such a decision-making power was exercised in the interest of the company.[162]

Reed by reliance on cases such as *Re City Equitable Fire Insurance Co* and *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd*,[163] has pointed that because judging business decisions/judgments (as opposed to the issue of management oversight as

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[157] [1988] Ch 114 (Ch) 6
[158] [1990] 1 CH 656 (CA)
[159] Per Lord Lindley, 1 CH 656 (CA)
[160] [1919] 1 CH 290
[161] [1920] 1 CH 154 (CA)
[162] Per Knox J, *Smith v Croft (No. 2)* [1988] CH 114 (Ch)
[163] [1925] CH 407 (Ch) 429 & [1972] 2 KB 9 (CA) 32. See also Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 170

happened in cases like *re Baring Plc and Others (No. 5)*[164]) involve an evaluation or judgment of pros and cons of particular transactions from hindsight, the courts have traditionally been deferential when it comes to directors' decision that are of business judgment,[165] as long as the decision was made by the directors acting as an independent appropriate organ of the company (*Re City Equitable Fire Insurance Co* and *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* [166]).

The consistency of the UK judicial deferential approach as shown in the above cases remained in the *Howard Smith Ltd v. Ampol Petroleum Ltd*[167] with Lord Wilberforce with reference to *Hogg v Cramphorn Ltd*[168] made a clear and unequivocal statement regarding the judicial deference to company directors' business judgment as follows:

> … what is required is bona fide exercise of the power in the interest of the company: that once it is found that the director were not motivated by self-interest … the matter is concluded in their favour and that the court will not inquire into the validity of their reasons for making the issue[169] … it would be wrong for the court to substitute its opinion for that of the management, or

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[164] [1999] 1 BCLC 433 (Ch)
[165] Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 170
[166] [1925] CH 407, 429 (CA) & [1972] 2 KB 9 (CA) 32 (KB). See also Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 170
[167] [1974] AC 821 (PC)
[168] [1967] CH 254 (Ch)
[169] [1974] AC 821 (PC) 834

indeed to question the correctness of the management's decision, on such a question, if bona fide arrived at.[170]

On the basis of the above, Lord Wilberforce concluded that the court has no jurisdiction to judge the right and wrong in the quality of a business judgment.[171]

Howard Smith Ltd Ltd v. Ampol Petroleum Ltd have become one of a leading case for the UK judicial deference and was relied or applied in many subsequent cases, notably, *Redwood Mater Fund Ltd v. TD Bank Europe Ltd*[172]; and *Dalby v. Bodily*[173].

It should be note that in regard to directors exercising their decision-making power in good faith or bona fide acting as an independent appropriate organ of the company for the purpose of invoking judicial deference, the standard of conduct relating the requirement of good faith is expected by the court to be "subjective" as unequivocally seen in the case of *Travel Insurance Limited v. Scattergood and Others*,[174] where the judge applied the subjective principle laid down in cases from Re *Smith and Fawcett Ltd*[175] through *Bristol & West Building Society v. Mothew*[176] to *Regencrest Plc v. Cohen*,[177] where '… it is perfectly clear that a directors' duty is to do what he

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[170] ibid
[171] ibid
[172] [2002] EWHC 2703 (CH)
[173] [2004] EWHC 3078 (CH)
[174] [2002] BCLC 1 (Ch)
[175] [1942] 1 CH 304 (Ch) 306
[176] [1998] CH 1 18 (CA)
[177] [2001] 2 BCLC 81 (Ch) 105a-h

honestly believes to be in the company's best interest.'[178] The judge was adamantly convinced that the requirement of good faith was to be based on the subjective standard even to the point where the directors' alleged belief was so unreasonable in the eyes of an ordinary person; the court would still deem the directors' state of mind in making the business decision based on good faith if 'it appears that the director did honestly believe that he was acting in the best interest of the company.'[179] In conclusion, the court ruled that in order to dis-apply judicial deference, it would not be sufficient for the company to show that the business decision/judgment of the director had caused the damage to the company, nor the business decision was not reasonable in the standard of an ordinary man, the company must also show that the director 'did not honestly believe that the'[180] business decision was made in the best interest of the company. It should be noted that there have been cases where the court adopt the objective test to determine whether or not the director had acted in good faith. This sort of judicial decisions has been arguably made to avoid the situation pointed out by Bowen LJ in the case of *Hutton v. West Cork Railway Co* 'Bona fide cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in the manner perfectly

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[178] *Extrasure Travel Insurance Limited v. Scattergood and Others* [2002] BCLC 1 (Ch) [90]
[179] ibid [90]
[180] ibid [97]

bona fide yet perfectly irrational.'[181] Therefore, as held by the judge in the more recent cases, *Charterbridge Corporation Ltd v. Lloyds Bank Ltd:*

> The proper test, I think, in the absence of actual separate consideration, must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company.[182]

Similar approach was adopted by the court in *Item Software (UK) Ltd v. Fassihi*[183] that if the director had acted in the absence of considering the interest of the company separately,[184] the court will objectively see if the business decision was a decision on which a reasonable director could have concluded.

From a broader perspective, academic writers such as Langford & Ramsay have pointed out that the approach of the good faith test is 'the duty is subjective in the sense that it is for the directors to determine **what are the interests of the company** and they **must** give actual consideration to the interests of the company.'[185] However, 'objective factors can be used by the court to determine if the director honestly

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[181] [1883] 23 CH 654 (CA) 671
[182] [1970] CH 62 (Ch) 74
[183] [2005] ICR 450 (CA) [41], [44]
[184] For instance, where the director has decided not to disclose the relevant business information to the company regarding his talk with third party company for the benefit of another company of which the director was going to set up. ibid [41], [44]
[185] Teele and Ramsay, 'Directors' Duties to Act in the Interests of the Company – Subjective or Objective' (2015) JBL 179

believes the decision they made was in the interests of the company'[186] where the business decision , in the court's view, had not been taken to be in the company's interest. This combined approach addresses the concern as raised by the judge in *Hutton v. West Cork Railway Co.*[187]

The above-mentioned approach was adopted by the judge in a recent Irish Case known as *Bloxham (in liquidation) v. Irish Stock Exchange ltd*[188] whereby the judge tried to maintain a balance between the avoidance of stepping into the shoes of the directors in their subjective belief of what was in the best interest of the company; and the objective steps taken by the court to ensure that the directors' business decision had been taken to fulfill their subjective belief. The judge said:

> For Bloxham, the argument goes the other way; in favour of the objective analysis of every decision made by a board of directors. Here the problem with be that in objective analyzing decisions, the courts might be in danger of stepping into the shoes of directors. This is not appropriate. The court cannot displace a decision simply because it does not like it[189] … Thus, it seems the best test for the exercise of the directors' duties must involve a scrutiny of whether a presence or absence of reasonable grounds enable what is said

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[186] ibid
[187] (n 131)
[188] [2014] IEHC 93
[189] ibid [9]

subjectively to be an honest decision to stand as being in the best interests of the company as a whole.[190]

Briefly, this subjective approach relating to the directors' business judgment (In determining the interest of the company) is important. As from a psychology perspective, the good faith requirement associated with judicial deference based on subjective standard is viewed to be an intrinsic motivator as opposed to extrinsic. For the purpose of the differences of the two types of motivations; and how each of these types decides the effectiveness of judicial deference with one arguably leads to directors' business creativity; and the other does not, will be discussed substantively in Chapter Four.

Boyle has pointed out an interesting fact that the enforceability subjecting to the condition of the continuing of the lawsuit in the best interest of the company (if not borrowed from the American law) shares a remembrance to the role/function of the special litigation committee[191] in American derivative lawsuit whereby, the court will discontinue the lawsuit once it is satisfied by the finding of the special litigation committee that the action was not in the interest of the company.[192] This is a relevant and important part of this chapter as I shall demonstrate in the next subsection that

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[190] ibid [11]

[191] A special litigation committee is set up by an independent board of director with the aim to successfully convince the court (through both legal and commercial factors) to discontinue the action – Model Business Corporation Act § 7.42.

[192] Boyle, 'The Judicial Review of the Special Litigation Committee: The Implications for the English Derivative Action after Smith v. Croft' (1990) Comp Law 3

similar concept to discontinue a derivative claim has been inherited by the Companies Act 2006 through the test of a hypothetical director under sections 263(2)(a) and 263(3)(b).

Back to the basics, the proper plaintiff rule aimed to ensure managerial decision being taken properly by an independent and appropriate organ of the company (rather than the court), however, the exception to the proper plaintiff rule allowed the minority shareholders to take derivative action, subject to the conditions that the director in question, must control the company in a particular situation,[193] or as the judge in *Burland v. Earle* described it as '… hold and control majority shares of the company …'[194]; and that this control could lead to the directors gaining personal benefits from the alleged wrong. This fraud on minority rule massively restricted shareholders' derivative remedies against directors to be available in the situations. For instance, where 'the company had suffered a wrong but the wrongdoer were in control of the company, and preventing it from initiating an action against them in respect of that wrong.'[195] Coupled with the internal management rule, it can be said that that the judicial deference on derivative action was, in common law, an indication of the court's diffidence in interfering with directors' business judgment.

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[193] '…a derivative claim is necessary only where there is a dispute between a member of a company and its director over the merits of bringing a claim (which alternatively will be a dispute with other members over the merits of ratifying a wrong so as to terminate the company's cause of action).' Mayson and French and Ryan, *Company Law* (23rd edn, OUP 2006-2007) 664

[194] [1902] AC 83 (PC) 93

[195] Keay and Loughrey, 'Something Old, Something New and Something Borrowed' (2008) 124 LQR 469, 472; see also generally, Demetra Arsalidou, 'Litigation Culture and the New Statutory Derivative Claim' (2009) Co Law 30(7) 206; Cabrelli, 'Derivative Actions: Part of Minority Shareholders' "Forensic Arsenal" in Scotland' (2003) SLT 73, 74

In other words, the judicial control of derivative action existed due to the courts' reluctance to get involved in the internal management of the company. Consequently, claims such as ordinary negligence would not have been eligible for the permission from the court to proceed with the derivative action,[196] as derivative action must have been brought against the directors on the ground of fraud on minority. For instance, in the case of *Smith v. Croft (No.2)* the judge said:

> In my judgment … votes should be disregarded if, but only if, the court is satisfied either that the vote or its equivalent is actually cast with a view to supporting the defendants rather than securing benefit to the company, or that the situation of the person whose vote is considered is such that there is substantial risk of that happening. The court should not substitute its own opinion but can, in my view, assess whether the decision-making process is vitiated by being or being likely to be directed to an improper purpose.[197]

This explains the reason as to why cases against director's ordinary negligence prior to Companies Act 2006 were brought against directors by companies' liquidator in the insolvency of the companies, which in turn, represented an indirect way to which shareholders could derivatively instigate legal action against directors for their

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[196] See Pendell, 'Derivative Claims: A Practical Guide' (2007) Co LN 1; and David Kershaw, 'The Rule in *Foss v. Harbottle* is dead: Long Live the Rule in *Foss v. Harbottle*' (2015) JBL 274-302, 274

[197] [1988] CH 114 (Ch) 186. See also *Pavlides v. Jensen* [1956] (CH) 565 (Ch) the director was not held to have gained personal advantage from his business decision, thus the minority shareholder was not entitled to bring the derivative action.

negligence.[198] Also, as pointed out by Armour et all that the wrongdoer's control rule had rendered the standing to bring a derivative action extremely difficult, particularly to public trading companies. This was 'due to rarity of blockholders' combining with the concept of fraud on minority which requires the involvement of the wrongdoers gaining personal benefits from the alleged transaction at the company's cost.'[199]

As pointed out by academic writers such as Boyle, that this diffidence of the court to interfere with the business judgment of the directors was further manifested in the case of *Smith v. Croft (No.2)*,[200] whereby the court took steps to ensure the degree of difficulty in achieving the enforcement of derivative action by minority shareholders under the wrongdoer's control rule through 'the most innovative feature' known as 'majority within the minority'.[201] Or as Stallworthy described, 'the minority applicant will … be required to adduce evidence of majority support amongst the so-called independent minority.'[202] This means that even if the claimants were minority shareholders, when taking out the majority directors/shareholders from the equation, the claimants became the minority within the group of non-directors – shareholders, then the *Foss v. Harbottle* **exception** could not apply. Consequently, the claimant would lose the right to sue. In other words, derivative action would not

[198] See for instance, *Barrett v. Duckett* [1995] 1 BCLC 243 (CA) as cited by David Kershaw, 'The Rule in Foss v. Harbottle is dead: Long Live the Rule in Foss v. Harbottle' (2015) JBL 2, 4

[199] Armour et al, 'Private enforcement of corporate law: an empirical comparison of the United Kingdom and the United States' (2009) JELS 694

[200] [1988] CH 114 (Ch)

[201] Boyle, 'The Judicial Review of the Special Litigation Committee: The Implications for he English Derivative Action after Smith v. Croft' (1990) Comp Law 3

[202] Stallworthy, 'Minority rights and the Continuing Thrall of Foss v. Harbottle' (1988) Conv May-Jun 210

have been allowed if the decision of the majority shareholder not to sue had been taken independently of the directors targeted to be sued. This is because the decision not to sue would not constitute fraud on minority unless the decision was not taken in good faith and in the interest of the company.[203] Looking at this from a simpler perspective, it can be said that the majority shareholders represented the company; and the court reverted to the principle of *Foss v. Harbottle* by not allowing derivative action when the company could not or unwilling to litigate.

This broad extent of judicial deference shared a striking resemblance to the American concept of business judgment rule. This is so, in the sense that both rules precluded actions, such as action on ordinary negligence against the director satisfying a number of pre-conditions. Namely, acting in good faith without an element of self-interest through majority control or fraudulent on minority shareholders (*Shaw v. Davis*[204]; *Kessler v. Ensley Co.*[205]; *Daniels v. Daniels*[206] & *Grobow v. Perot*;[207] and *Black v. Fox Hill North Community Assoc.*[208]). In addition, the underlying principle for the judicial deference on both systems was based on judges' diffidence to interfere with the decision-making powers of the director. As the judge in *Kamin v. American*

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[203] *Smith v. Croft (No.2)* [1988] Ch 114 (Ch) 186
[204] 28A. 621 [1894]
[205] 123 Fed. 558 [1903]
[206] [1978] CH 406 (Ch) as cited and discussed by W, 'Minority Shareholders and Directors' Duties' (1978) Mod L Rev Vol 41, 569-572
[207] 539 A.2d 180 [Del. 1988]
[208] A.2d 1228, 1231[1992]

Express Co[209] stated that 'The director's room rather than the courtroom is the appropriate forum for thrashing out purely business decisions which will have an impact of on profits, market prices, competitive situations or tax advantages.' Similarly, the judge stated in *Overend Gurney & Co v. Gibb:*[210]

> I think it extremely likely that many a judge, or many a person versed by long experience in the affair of mankind, as conducted in the mercantile world, will know that there is a great deal more trust, a great deal more speculation, and a great deal more readiness to confide the probability of things with regard to success in mercantile transactions, than there is on the part of those whose habits of life are entirely of a different character. It would be extremely wrong to import into the consideration of the case of a person acting as a mercantile agent in the purchase of a business concern, those principle of extreme caution which might indicate the course of one who is not at all inclined to invest his property in any venture of such a hazardous character.

SUMMARY

As opposed to company directors' responsibilities relating to their internal control or functions, the legal position relating to derivative action against company directors in the context of their business judgment (prior to 2006 Act) was that the

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[209] 383 NYS 2[d] 807 [1976] Supreme Court as cited by Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 98, 117

[210] [1872] LR 5 (HL) 480, 495

court adopted a very strict deferential approach. As the court was to affirm the fundamental principle of proper plaintiff's rule through the right in decision making of the company exercisable by its collective shareholders and board of directors (all known as the appropriate independent organ of the company), directors were implicitly and indirectly protected by the court. Additional reasons for the judicial deference included the prevention of the non-business expert judges to second guess the business decision/judgment of directors, thereby risking the company being controlled of its corporate destiny; and excessive cases from clogging up the court system. Derivative action on ordinary negligence was thereby literally not possible unless the 'wrongdoer's control rule' through element of fraud on minority can be established by the shareholders to the satisfaction of the court. Even if the wrongdoer's control rule can be established, judicial deference could still be applied if the court was satisfied that the decision not to sue by way of business judgment was taken by the directors or other appropriate independent organ such as other shareholders; for the benefit of the company (*Smith v Croft (No. 2)*[211]) or that the directors' business judgment was made, regardless of its correctness, if 'bona fide arrived at'.[212]

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[211] [1988] Ch 114 (Ch) 6

[212] *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] AC 821 (PC) 834

LEGISLATED DEFERENCE IN THE CONTEXT OF DIRCETORS' BUSINESS JUDGMENT - THE POSITION UNDER THE COMPANIES ACT 2006

In the following section, I shall look into the changes of which the Companies Act 2006 has brought upon the common law judicial deference (relating to directors' business judgments) as per my discussion in the preceding sections. This section will demonstrate that despite the abolition of certain aspects of the common law judicial deference, the courts have retained the deferential approach on directors' business judgment. This section will discuss how the relevant legislation is operated by the judges and where the legislated can be located.

The common law strict extent of judicial deference has been significantly altered since the passing of Part 11 of the Companies Act 2006.[213] The current consensus amongst lawyers and academic writers such as Gibbs, Kershaw, Lowry & Reisberg, Arsalidou, Almadani and Adeyeye is that the control of wrongdoers rule has been arguably abolished by the Companies Act 2006.[214] This interpretation is witnessed by

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[213] It should be noted that this Chapter solely places its focus on the existence and the scope of judicial deference, therefore, any sub-section of section 263, e.g., refusal to continue derivative action based on company authorization or ratification; which has more relevancy to any matter complained, such as directors' salary remuneration being authorized by the company in advance or ratified thereafter (see Ndzi, 'Directors Excessive Pay and Shareholders' Derivative Action' (2015) 36(5) Co Law 144, 148); which do not bear direct relevance to judicial deference will not be covered.

[214] Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? A Prima Facie Case and the Mandatory Bar: Part 1' (2011) Co Law 41; Arsalidou, 'Litigation Culture and the New Statutory Derivative Claim' (2009) Co Law 206; Almadani, 'Derivative Actions: Does the Company Act 2006 Offer a Way Forward?' (2009) Co Law 131, 132; Adeyeye, 'The Limitations of Corporate Governance in the CSR Agenda' (2010) Co Law 31(4) 114, 118; Kershaw, *Company Law in Context: Text and Materials* (OUP 2009) 551; Pettet, *Pettet's Company Law*, edited by J. Lowry and A. Resberg, (3rd edn, Harlow: Pearsson, 2009) 250; Davies, Gower and Davie, *Davies, Gower and Davie's Principles of Modern Company Law* (8th edn, Sweet and Maxwell 2008) 615 all cited by Kershaw in 'The Rule in Foss v. Harbottle is Dead: Long Live the Rule in *Foss v. Harbottle*' (2015) JBL 2-26

the fact that as opposed to the common law, under the Act, derivative claims are now made available to shareholders against director's negligence etc. (Section 260(3)). This means that the relevant sections are not strictly a codification of the common law.[215] This is further supported by the legislative history of Part 11 which would provide a clear indication of the enactment which is based on the Law Commission's recommendations to abolish the control of wrongdoers' rule with an aim to place companies to greater exposure to derivative claims. As overtly stated by Keay and Loughry that

> The aim behind this innovation, which is largely based upon the recommendations of the Law Commission, is the simplification and modernisation of the law in order to improve its accessibility.[216] To achieve this, the arcane rule in *Foss v. Harbottle*, and the concept of 'fraud in minority' and 'wrong doer's control', have been discarded and replaced by a judicial discretion to grant permission, which to be exercised by reference to statutory criteria set out in ss. 261-263 of the Act.[217]

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[215] 'New CPRs Published for Statutory Derivative Claim' (2007) Co LN 13, 14; J. Paul Sykes, 'The Continuing Paradox: A Critique of Minority Shareholder and Derivative Claims under the Companies Act 2006' (2010) CJQ 2-25, 8; Kershaw, 'The Rule in Foss v. Harbottle is dead: Long Live the Rule in Foss v. Harbottle' (2015) JBL 2, 2.; Slaughter & May Online Article (2007) https://www.slaughterandmay.com/media/39392/companies_act_2006_-_directors_duties_derivative_actions.pdf; accessed 2017

[216] La Commission, Shareholder Remedies: Report on a Reference under Section 3(1)(e) of the Law Commission Act recommendations in England and Wales (Law Com. No. 246, Cm. 3769, 1997) 7 as cited by Keay and Loughrey, 'Something Old, Something New and Something Borrowed' (2008) 124 July LQR 469

[217] ibid 482

The abolition of the common law wrongdoer's control rule means that judicial deference is no longer automatically applicable to a proposed derivative claim. In other words, shareholders failure to establish any personal gain on the director's majority control does not preclude the possibility of the director being sued, e.g., for negligence.[218] However this does not mean an abolition of judicial deference all together at the enforcement stage of a derivative claim, nor does it indicate a reduction in the degree of deference. As I shall demonstrate in the latter part of this section, courts are still very much diffident in interfering with directors' business decisions/judgments. In other words, the traditional common law concept of decision made bona fide by an independent appropriate organ of the company; and the judicial respect of Directors' business judgment can still very much be found throughout Part 11 of Companies Act 2006. To understand this, I would first briefly introduce the judicial procedures under the Act and conceptually lead up to the aspects of which legislated deference is located.

Kershaw has said that under Companies Act 2006:

> … once the action has been commenced the derivative claimant must apply to court for permission to continue the litigation just as under the old rules a litigant had to obtain permission to bring a derivative action in a preliminary hearing. The Act provides for a two-stage permission process. At the first stage

[218] Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? A Prima Facie Case and the Mandatory Bar: Part 1' (2011) Co Law

> the court must determine on the evidence filed with the application whether there is a 'prima facie case for giving permission'. At the second stage, where the permission decision is made, evidence from the company will also be admissible.[219]

It has been taken that the new regime of the 2006 Act had set a lower standard as the burden of proving a prima facie case appears to have been now lifted from the shareholders as in the case of *Wishart.*[220] Where the judge said that the burden of establishing a prima facie case should not be placed upon the shareholders, rather, it is for the court to disapprove a prima facie case if there is to be a refusal on permission to continue. In *Wishart*, to establish a prima facie case, the judge dealt with a number of basic elements including identifying the applicant as members of the company, the derivative nature of the application and the cause of action and facts relating to the application.[221] The *Wishart* approach was adopted by the judge in a subsequent case in England and Wales known as *Stimpson v. Southern Landlord Association.*[222]

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[219] David Kershaw, 'The Rule in Foss v. Harbottle is dead: Long Live the Rule in *Foss v. Harbottle*' (2015) JBL 2 7; and Keay and Loughrey, 'Something Old, Something New and Something Borrowed' (2008) 124 LQR 469, 482 & 483; Lightman, 'The Role of the Company at the Permission Stage in the Statutory Derivative Claim' (2011) CJQ 30(1) 23, 24-28; Tang, 'Shareholders' Remedies: Demise of the Derivative Claim?' (2012) UCL 178

[220] [2009] CSIH 65 (CSIH); 2009 SLT 812, [31]. See also Keay and Loughrey 'Derivative Proceedings in Brave New World for Company Management and Shareholders' (2010) JBL 3

[221] Keay and Loughrey 'Derivative Proceedings in Brave New World for Company Management and Shareholders' (2010) JBL 3

[222] [2010] BCC 387 (Ch) H13.8. See also Keay and Loughrey 'Derivative Proceedings in Brave New World for Company Management and Shareholders' (2010) JBL 3

However, Lewison J. in *Iesini v. Westrip Holdings Ltd*[223] disagreed with *Wishart* approach and reverted the burden of establishing a prima facie case back to the applicants citing that this was a correct approach laid down in *Prudential Assurance Co Ltd v Newman Industries Ltd.*[224]

If Lewison J.'s interpretation in *Iesini v Westrip Holdings Ltd* was correct, Keay has suggested that it would be sensible to mean that both first and second stages of the application being combined into one. Otherwise, it would be difficult, if not impossible, for one to disguise the nature of the two stages.[225] However, duplication of works will be involved which is likely to result in higher cost. To this end, Keay has suggested that the first stage is only likely to involve limitations, '… to making sure that a claim is not bogus and should involve the court ensuring that the applicant is a member of the company and the application relates to derivative proceedings, as required by the court in *Wishart.*'[226]

The second stage is where the court's diffident in second-guessing the managerial discretion is found. To demonstrate this, one has to first set out the basic understanding of the law. Under the second stage, the applicant must satisfy good faith requirement and under Section 263(2)(a) Companies Act 2006. Under the same

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[223] [2010] BCC 420 (Ch)
[224] [1982] Ch 204 (CA)
[225] Keay and Loughrey 'Derivative Proceedings in Brave New World for Company Management and Shareholders' (2010) JBL 3
[226] Keay and Loughrey 'Derivative Proceedings in Brave New World for Company Management and Shareholders' (2010) JBL 3

section, the courts must refuse permission to continue a derivative action 'If the court is satisfied that the person acting in accordance with Section 172 (duty to promote success of the company) would not seek to continue the claim.'[227] In this respect, the statute retains the old common law rule for the judge to discontinue the derivative action, on the ground that the decision not to sue was taken by an appropriate independent organ of the company, e.g., directors, in good faith and for the benefit of the company[228] - *Smith v Croft (No. 2)* where the judge said that 'If it is an expression of the corporate will of the company by an appropriate independent organ that is preventing the plaintiff from prosecuting the action he is not improperly but properly prevented …' [229]

Section 172 Companies Act 2006 provides that:

> 1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
>
> (a) the likely consequences of any decision in the long term,
>
> (b) the interests of the company's employees,

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[227] See also Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? A prima Facie Case and the Mandatory Bar: Part 1' (2011) Co Law 41

[228] *Taylor v. National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237 (HC) 225 6

[229] [1988] CH 114 (Ch) 184

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

(2) where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) the duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

The Companies Act 2006 contains further provision in Section 263(3)(b) requiring the judge to take compliance of Section 172 into account in exercising its discretion on whether or not to permit continuance of the action.

However, on the basis that Section 263(2)(a) requires firmly that the judge to refuse permission if the claimant is not acting in accordance to Section 172 whilst Section 263(3)(b) asks the judge to take Section 172 into account on discretionary basis, confusion has arisen amongst some lawyers. As the Act does not provide legal

certainty as to how Sections 263(2)(a) and 263(b) co-exist, Andrew Keay has suggested that:

> … perhaps one solution is to say that the judges are given the flexibility 'in the face of uncertainty associated with the Section 172 hypothetical director determination,' that is, if the judge is uncertain as to whether a person would decide whether or not to continue the claim, he or she will not reject the application under Section 263(2)(a) and then he or she can assess the probability of a director continuing the action in the context of the factors in Section 263(3) and (4).[230]

This approach appears to be correct in the recent cases of *Mission Capital plc v. Sinclair* where the judge was under the opinion that the notional director would not discontinue the claim under Section 172, the judges was also under the opinion that such a notional director would put too much degree of importance on continuing the action when considering the relevant evidence and information, '... and so, the permission application failed ultimately.'[231]

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[230] Andrew Keay, 'Application to Continue Derivative Proceedings on behalf of Companies and the Hypothetical Director Test' (2015) CJQ 346, 360; *Mission Capital Plc v Sinclair* [2008] EWHC 1339 as cited to support this judicial approach by Arsalidou, 'Litigation Culture and the New Statutory Derivative Claim' (2009) Co Law 30(7) 205, 208

[231] [2009] EWHC 1339 (Ch); [2008] BCC 866 (Ch). See also Andrew Keay, 'Application to Continue Derivative Proceedings on behalf of Companies and the Hypothetical Director Test' (2015) CJQ 346, 360

As pointed out by Kershaw while Section 263(b) requires the court to take into account of compliance of Section 172 on the part of 'a person', it 'does not specify who this hypothetical person is.'[232] Kershaw further pointed out that one 'would expect the court to ask whether a reasonable director acting in accordance with Section 172 would **not** seek to continue the claim.'[233]

Through the lens of a hypothetical reasonable director the court are being asked, in effect to make their own business judgment about whether it makes sense for the continue the action commenced by the shareholders. The court therefore, becomes the filter mechanism for distinguishing between the potential good and bad – from the company's perspective – of derivative claim.[234]

When determining whether or not a hypothetical director is acting in accordance with Section 172, he or she must first satisfy the good faith requirement. This is based on an objective test as stated by Pennychuick J in *Charterbridge Corporation Ltd v. Lloyds Bank Ltd*[235] as follows:

The proper test, I think, in the absence of actual separate consideration, must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company.

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[232] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 613
[233] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 613
[234] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 613
[235] [1970] CH 62 (Ch) [74]

This means that if the hypothetical directors had acted without independently taking the company's interest into account, the decision not to continue the action of the hypothetical director would still be deemed to have taken in good faith if the objective test can be passed.

Under normal circumstances, and as mentioned in the preceding section discussing the wrongdoer control rule in the common law, the test for the good faith requirement in common law relating to decision taken by an appropriate independent organ of the company (the hypothetical director in this case) in determining what are the interests of the company will be subjected to a subjective approach[236] (subject to the exception where the decision is a complete irrational one as identified by Bowen J in *Hutton v. West Cork Railway*[237] then an objective test will apply). If we take the common law approach, the subjective approach will be taken by the court as a benchmark to assess whether or not the hypothetical director had acted, in good faith, to promote the success of the company in the course of discontinuing the derivative claim (see for instance, *Kiani v. Cooper*[238]). As pointed out by Reed, the common law subjective approach is particularly relevant where the commercial factor as opposed to legal

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[236] *Extarsure Insurance Limited v. Scattergood* [2003] 1 BCLC (Ch) [90], [97]

[237] [1883] 23 CH 654 (CA) 571

[238] [2010] BCC (Ch) [36], [37] where the subjective test was applied by the court in deciding whether or not the director was acting in good faith to having instructed her husband to covertly transfer certain sum of money from the company's bank account prior to the disputed event.

factor of which the courts have traditionally refused to second-guess company directors' business judgment.[239]

For the purpose of Section 263(2)(a), the good faith requirement is linked to the success of the company, in that, the basis of which a hypothetical director would believe that the continuing lawsuit would be in the interest of the company would much depend on the success rate of the case, the legal cost plus the amount of compensation to be obtained (*Franbar Holdings Ltd v. Patel*[240], *Kiani v. Cooper*[241] & *Zavahir v. Shankleman*[242]).

However, the legal factor with the amount of financial compensation is not the only factor to be considered. As mentioned above, there are also commercial factors (or as this thesis consistently describe – business judgments) of which a judge might also consider in light of section 263(2)(a). In the case of *Iesini v. Westrip Holdings Ltd*, Lewison J make the following statement with reference to the opinions of Warren J; and Mr William Trowell Q in *Airey v. Cordell*[243]; & *Franbar Holdings Limited v. Patel*[244] respectively in an attempt to resolve the potential inconsistencies on what

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[239] Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 171

[240] [2009] 1 BCLC 1 (Ch) 11

[241] [2010] BCC (Ch) [44]

[242] [2016] EWHC 1534 (Ch) as cited by Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 613; See also, *Zavahir v. Shankleman* [2016] EWHC 2772 (CH) (CH D (Companies CT)) as covered in Case Comment, 'Application for Permission to Continue Derivative Claim Refused' (2016), CLN

[243] [2007] BCC (Ch) 785, 800 - 'If the test of a reasonable board is to be applied, it has to be recognised that, in many cases at least, a decision either way could be one which at reasonable board could take.'

[244] [2009] 1 BCLC 1 (Ch) 11

view a reasonable director would take in deciding whether or not he is acting in accordance with Section 172:

> … where many cases in which some directors acting in accordance with Section 172, would think it worthwhile to continue a claim at least for the time being, while others also acting in accordance with Section 172, would reach the opposite conclusion. There are, of course, a number of factors that a director, acting in accordance with Section 172, would consider in reaching his decision. They include; the size of the claim; strength of the claim …. Any disruption to the company's activities whiles the claim is pursued …and so on the weighing of these consideration is essentially a commercial decision, which the court is ill-equipped to take, except in a clear case.[245]

With regard to the above statement, Lewison J simply concluded that 'If some directors would and others would not, seek to continue the claim, the case is one for the application of section 263(3)(b).'[246] Indeed, as we can see from the statement, whilst the judge in *Iesini* acknowledged that the commercial factors represent part of the factors in Section 172, he refused to take those factors into account for the purpose of section 263(2)(a). This refusal was based on the traditional ground of 'judges are ill-equipped to take',[247] or, to put it simply, from a famous legal

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[245] *Iesini v. Westrip Holdings Ltd* [2009] EWHC (Ch) [80] as cited in Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 615-616;
[246] ibid
[247] ibid

expression - 'judges are not business experts' as expressed by the judge in *Dodge v. Ford Motor Co.*[248] Even though the main purpose of Lewison J's statement above was to address the application difference between sections 263(2)(a) and 263(3)(b), one can see the classical judicial behaviour of the court's diffidence in interfering with company directors' business judgment. Thus, preserving the business creative discretion of directors, by citing the lack of business expertise amongst the judges (except in the case of gross negligence).

Indeed, as Gibbs puts it, that the judge was not equipped to get himself involved in considering the commercial factors/business judgments and would therefore, prefer to stay within the confinement of the law than within the commercial realm, in deciding whether or not a hypothetical director would continue the action - 'demonstrating there was no breach of duty and where it was impossible to say whether there was negligence.'[249]

The court's decision in *Iesini* followed the footstep of the decision in *Overend Gurney & Co v. Gibb* where the judge took a deferential approach on the basis that the court was not a business expert; and that the business judgment or Non-Programmed (Creative) Business Decision-making[250] should be the prerogative of company directors who are more prepared 'to confide in probabilities of things, with regard to

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[248] 170 NW 668, 684 [Mich. 1909]; see the two terms are used inter-changeably in Kenneth B Davis, Jr, 'Once More, The Business Judgment Rule' (2000) Wis Law Rev 573, 580

[249] Gibb, 'Has the Statutory Derivative Claim fulfilled its Objectives? A Prima Facie Case and the Mandatory bar: Part 1' (2011) Co Law *43*

[250] (n 95)

success in mercantile transactions, than there is on the part of those habits of life are entirely of a different character'.[251] With *Overend Gurney & Co v. Gibb*, there was a clear judicial deference in favour of the director, whereas with *Iesini*, the reason of judges not being business experts was used only for the purpose of the dis-application of Section 263(2)(a), which result in permission being initially suspended and opened an opportunity for the judge to conclude deference under section 263(3)(b). Though in different ways, both deferential approaches indicated that the courts are diffident to interfere with directors' business judgments. In other words, this shows the court to be continuously reluctant to 'disrespect' the internal management rule through its diffidence to interfere with the business judgment of the directors. And as my Chapter Three will demonstrate giving insight into the nature of business judgment - where the business decision-making is a matter of creativity.

In order to determine whether or not the business decision is a business judgment, i.e., a creative decision,[252] the judges have shown the tendency to try to make sure that there is an absence of any predefined rule of which the assessment of the decision can be based upon. For instance, the judge in *Overene & Guerney v. Gibb* classified the business judgment as the types of business decision with 'a great deal more speculation' and a great deal of 'probability of things'. Similarly, as in the case of *Lesini*, we can see that court in struggling to reach a certainty as to what constitute

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[251] *Overene & Guerney v. Gibb* [1872] LR 5 (HL) 480

[252] Or as this thesis dupes – Non-Programmed (Creative) Business Decision.

certain commercial decision, and eventually due to the uncertainty (or the absence of any predefined rule of which the business decision-making is bound), the court concluded to move the request to continue the claim to section 263(3)(b). This is the section where a non-exhaustive list of commercial factors can be taken into account in determining whether or not to discontinue the claim. This is so, because of the unavailability of a definite position.[253] And therefore, it is a matter of internal managerial discretion of the directors. Indeed, Lewison J does not rule out situations **in a clear case** of weighing the business and legal factors, the possibility of accepting those business factors (to discontinue the permission sought), which arguably, is in line with the provisions of Section 172 that consists of a list of non-litigious factors. This consequently widens the scope of the application of judicial deference on the basis that factors that could discontinue derivative action are non-exhaustive both from legal and business (and for the purpose of this thesis – commercial factor in line with business creativity) perspectives.

Where the court is able to calculate the merit of the hypothetical directors' decision to continue the action, the court will interfere. As these decision are not traditionally being regarded as business judgments due to their predictability as was not being the type of decision that was excluded from judicial intervention in the case of *Overend Gurney and Co v Gibb.*[254] Reisberg[255] and Gevurtz[256] have identified a number of

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[253] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 616
[254] [1872] LR5 (HL) 580

demerits of derivative litigation, e.g., in order to preserve the confidence of directors in their business decision-making, the litigation would bear a consequential effect on future directors with sufficient liability insurance or a massive increase of salary as an inducement to directors which ultimately has the effect of off-setting the monetary compensation received from the directors.

Section 263(3)(b) and court's diffidence to interfere with directors' business creative discretions: as confirmed by Lewison J and illustrated by the academic writers such as Kershaw and more precisely by Keay and Gibbs, the judicial deference under Section 263 adopts a two-stage approach. This means that if the judge is not sure as to whether or not to refuse to discontinue the claim under section 263(2), the judge will not grant the permission under Section 263(2) and the judges then 'must exercise its discretion in determine whether a claim can continue.'[257] Section 263 followed the common law approach in regard to the non-exhaustive list of 'probabilities of things'[258] regarding the transactions in business world, by containing a non-exhaustive list of factors that the judge is required to take into account in exercising such discretion and as pointed out by Gibbs, Keay and Lourey that the court would therefore, be able to take all relevant considerations into

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[255] Reisberg, 'Shareholders' Remedies: the Choice of Objectives and the Social Meaning of Derivative Actions' (2005) EBEOR 6(2) 227, 232

[256] Franklin A. Gevurtz, *Corporation Law* (2nd edn, West Academic Publishing 2010) 294

[257] *Iesiniv. Westrip Holdings Ltd* [2009] BCC (Ch) 420 [86]; Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 620; Andrew Keay, 'Application to Continue Derivative Proceedings on behalf of Companies and the Hypothetical Director Test' (2015) CJQ 2, 14; see also Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? A prima Facie Case and the Mandatory Bar: Part 1' (2011) Co Law 41

[258] *Overend & Guerney v. Gibb* [1872] LR 5 (HL) 480

account.[259] The court's right to the non-exhaustive list under section 263 was affirmed by the court in a recent case known as *Stimpson v Southern Landlords Association*[260] to include a hypothetical director acting in good faith in line with section 172. Following the non-exhaustive list of factors available to judges, it can be said that the common law approach of judges refusing to second-guess business judgment of directors in order to preserve the business creative/managerial discretion exclusive to the board acting as an appropriate independent organ of the company[261] remains a factor. In other words, the traditional factor as seen in *Howard Smith Ltd v. Ampol Petroleum Ltd*[262]; *Smith v Croft (No. 2)*[263]; and *Extrasure Travel Insurances Limited v. Scattergood and Others*[264] that judges are ill-equipped to assess a commercial factor would first be applied on a subjective good faith basis to ignore section 263(2)(a) as seen in *Iesini*, and would also be likely due to judges' diffidence in interfering with corporate management, be a factor for the judges to exercise their discretion to discontinue the derivative claim under section 263(3)(b). And as a specific part of internal business decision, I would argue and demonstrate, from a psychology perspective, in the following chapters, that directors' business creativity

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[259] Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? A prima Facie Case and the Mandatory Bar: Part 2' (2011) Co Law 81; and Keay and Loughrey, 'Something Old, Something New and Something Borrowed' (2008) 124 LQR 469, 473; and Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 620

[260] [2010] BCC 387 (Ch). See also case comment *'Stimpson v Southern Landlords Association*: Permission to Continue Derivative Claim Refused' (2010) Co Law 277, 283-284; and see also Tang, 'Shareholders' Remedies: Demise of the Derivative Claim?' (2012) UCL 182

[261] *Carlen v. Drury* [1812] 35 ER 61 (Ch); *Smith v Croft (No. 2)* [1988] (Ch) 114

[262] [1974] UKPC 3 (PC)

[263] [1988] CH 114 (Ch)

[264] [2002] 1 BCLC 598 (Ch) [90], [97]

and the psychological impact as a consequence of the derivative claim logically represent an essential factor that justifies the court's diffidence, hence, judicial or legislated deference.

The court showed a clear diffidence in second-guessing the director's business judgment in an attempt to preserve the internal management discretion of the company directors in *Kleanthous v. Paphitis.*[265] Where Newey J followed the no-threshold on the merits principles laid down by Roth J in *Stainer v Lee*[266] & Lord Reed in *Wishart v Castlecroft Securities Ltd*[267] to conclude the general commercial factors, such as the adverse effect of litigation on the director's business decisions to cause disruption to the company employees' morale as a whole, including the senior management; and (for the purpose of this chapter) most importantly, losing company directors which in turn, would damage the company's future trade performance; and any damage to the company's reputation 'as a result of publicity and disclosure arising from the litigation'.[268] All will have 'much force'[269] in judges' minds with the consequential result in the discontinuing of the derivative action.

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[265] [2011] EWHC (Ch) [71], [72] & [75]

[266] [2010] EWHC 1539 (Ch) as cited by Newey J in *Kleanthous v. Paphitis* [2011] EWHC, (Ch) [40]

[267] [2009] CSIH 63 (CSIH) [37] as cited by Newey J in *Kleanthous v. Paphitis* [2011] EWHC (Ch) [71], [72] & [73]

[268] *Kleanthous v. Paphitis* [2011] EWHC (Ch) [71], [72] & [73]. Also mentioned in Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 613

[269] *Kleanthous v. Paphitis* [2011] EWHC (Ch) [71], [72] & [73]. Also mentioned in EWHC 2287 as cited by Kershaw, *Company Law in Context: Text and Materials* (2nd edn, 2012) 622

As pointed out by Newwey J following Lord Reed in *Wishart v Castlecroft Securities Ltd*, the decision of the judge in *Paphitis* case in considering to discontinue the action by putting 'much force'[270] on the business factors beyond the mere success chance of the claim is indeed, closer in line with the provision of Section 172, as the section require the directors to take into account of the company's welfare in general. This is including non-litigation factors, such as the likely consequences of the business decision to the company in the long-run.[271]

By placing business factors in line with Section 172 as a justification to discontinue the lawsuit would mean that the court is unwilling to interfere with directors' business judgment. This is achieved (in the event that there is a conflict between the legal and business factors) through its recognition of the danger of the company having a great chance of success in winning a case awarding a substantial damage against the director, at the expense of detrimentally affecting the corporate management of the company which could, and I argue, result in de-motivation on the directors' business creativity. And in long run, damaging the company's economy.[272] This deferential approach bears a striking remembrance to the US business judgment rule, whereby

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[270] ibid [73]

[271] *Wishart v Castlecroft Securities Ltd* [2009] CSIH 65 (CSIH) [37] as cited by Newey J in *Kleanthous v. Paphitis* [2011] EWHC (Ch) [71] – it should be noted that the judge's decision to discontinue the claim in *Kleanthous v. Paphitiswas* was not solely attributed to judges being unequipped to deal with the directors' commercial decision, it was also based on other non-commercial decision factors such as availability of alternative remedies, i.e., unfair prejudice; and that the distribution of the money would end up being returned to the defendant directors anyway. The commercial factor, however, plays a key role in influencing the judge's decision.

[272] See Chapter Four relating to the significance of directors' business creativity in companies' business.

judges are not prepared to interfere with the directors' business decision in the fear of directors becoming risk adverse with consequential damage to the company's trade performance in the future.[273]

In other words, the deterrent by way of monetary value awarded to the company in short run can be under-deterrent. This line of rationality has been pointed out by Reisberg where, the continuing of derivative action may, as described by Reisberg, 'have a chilling effect' on the director's willingness of business risk taking, thus hurts the corporate management as a whole.[274] Although the judge's decision to discontinue the claim in *Kleanthous v. Paphitis* was not solely attributed to judges being unequipped to deal with the directors' commercial decision. It was also based on other non-commercial decision factors such as availability of alternative remedies, i.e., unfair prejudice; and that the distribution of the money would end up being returned to the defendant directors anyway. The willingness of the court to put 'much force'[275] on commercial factors in discontinuing the derivative action in *Paphitis* case demonstrates a strong judicial diffidence in interfering with delegated managerial discretion exercised by the hypothetical director).[276] And (as per my discussion in the preceding section of the chapter) this goes back to the traditional view by the judiciary that the decision of continuing the derivative action must be made, bona fide,

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[273] Alfred. F. Conard, 'A Behavioral Analysis of directors' Liability for Negligence' (1972) Duke LJ 904; and Einsenbeg, 'The Duty of Care of Corporate Directors' (1989-1990) 51 U Pitt L Rev 958-959

[274] Reisberg, 'Shareholders' Remedies: the Choice of Objectives and the Social Meaning of Derivative Actions' (2005) EBEOR 6(2) 227, 239

[275] *Kleanthous v. Paphitis* [2011] EWHC (Ch) [73]

[276] ibid [75]

by an appropriate independent organ in the interest of the company (*Smith v Croft (No. 2)*[277]).

SUMMARY

The common law policy that derivative action is totally not actionable unless wrongdoer's rule is satisfied has been abolished by Part 11 of the 2006 Act. This, however, does not lead to a reduction of the courts' deferential behaviour at the enforcement stage. Nevertheless, it does mean a shift of focus on the judicial determination of the application of legislated deference. Courts are now prepared to entertain derivative claim even if the director has not made a personal gain through majority control, but only on the basis that the action was justified by way of good faith and in the interest of the company. This in turn, broadens the scope of legislated deference through a list of non-exhaustive factors (both legal and business factors) that can be considered by the court. The availability of the non-exhaustive list of commercial factors under section 262(3)(b) reflects the court's traditional approach to refrain from second-guessing directors' business judgment.

In other words, rather than judicial deference based on the limited scope of the application of wrongdoer's control rule/fraud on minority, courts are finding themselves now in the position of able to adopt the deferential approach. A deferential approach closer in line with the prior common law approach to avoid minority

[277] [1988] CH 114 (Ch)

shareholders in disrupting the creative decision-making (or business judgment) of the board. This is done by having a wider discretionary power/task in determining whether or not the presumption of legislated deference can be rebutted by the shareholders. Shareholders are now subject to the hypothetical directors' test with the risk of failing to continue the claim under a non-exhaustive list of factors from which, the judges can take the view that, from a bona fide perspective of a hypothetical director, the continuation of the derivative claim is not in the best interest of the company; hence legislated deference be applied.

With the wider discretionary power contained in the Companies Act 2006, the court has in recent cases exercised a strong diffidence in interfering with managerial discretion of company directors in the face of the statutory procedures. The legislated deference, expressed in the cases, e.g., *Howard Smith Ltd v. Ampol Petroleum Ltd*,[278] *Smith v Croft (No. 2)*[279] & *Allen v. Gold Reefs of West Africa Ltd*[280] through the underlying principles that the business judgment being made, bona fide, by an appropriate independent organ (now the hypothetical director) of the company remains a commonplace - Stimpson v Southern Landlords Association[281]; & *Kleanthous v. Paphitis.*[282] As pointed out by Gibbs, 'Directors still have upper hand

[278] [1974] UKPC 3 (PC)
[279] [1988] CH 114 (Ch)
[280] [1900] 1 CH 656 (CA)
[281] [2010] BCC 387 (CA)
[282] [2011] EWHC (Ch) 2287

in these claims … the so-called balancing act of meritorious claims against directors' good faith decision is skewed heavily towards directors.'[283]

However, as the 2006 Act is still relatively young in comparison to its common law predecessor or the US business judgment rule, the statutory exposition under Section 263 to assist judges to apply the legislated deference contains a non-exhaustive list of business factors which is opened to further exploring and analysis. This thesis aims to contribute to the understanding of: 1. the significance of business creativity[284]/business judgment as an appropriate basis underpinning judicial or legislated deference in directors' business decisions, with the desiring effect of being in the interest of the company; and 2. how the absence of the legislated deference can be against the interest of the company by way of de-motivating directors' business creativity. All these issues will be identified with a solid theoretical basis that leads to the formulation of a particular type of business decision, from a management psychology perspective, known as programmed and Non-Programmed (Creative) Business Decision.

MOTIVATION, CREATIVITY, SECTIONS 263 & 172

'Business creativity' being part of delegated form of managerial discretion to board of directors acting as an appropriate independent organ of the company. Section

[283] Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? A prima Facie Case and the Mandatory Bar: Part 2' (2011) Co Law 82
[284] (n127)

172 requires the directors to promote the success of the company; and to do so requires the directors to take into account of a list of general factors such as the likely consequence of the business decision in the long run and the need to foster the company's relation with its suppliers, customers and others all embodied in the delegated form of managerial discretion. It can be strongly argued that business creativity represents a specific factor that permeates most, if not all, the general factors on Section 172 list.

In recent cases such as *Wishart v Castlecroft Securities Ltd*;[285] and *Kleanthous v. Paphitis*,[286] judges have repeatedly expressed the significance of business creativity through the recognition of losing of directors and their business skills as commercial factors damaging the trade performance of the company to justify judicial/legislated deference.

Not all types of business decisions are of creative nature, therefore, the objective standard of conduct based on a hypothetical director (within the context of Sections 263(2)(a) and/or 263(3)(b)) will be part of the central focus relating to the necessity of my proposed judicial/legislated deference based on types of business decisions. It is the aspect of working out a mechanism of an existing concept of section 172 – judicial/legislated deference based on business creativity, that I shall borrow the normative approach of US business judgment rule with an explanation of the

[285] [2009] CSIH 65(CSIH)
[286] [2011] EWHC (Ch)

underlying justification from psychology which is primarily based on a set of clearly predefined conditions to give a clearer picture of the objective benchmark based on a hypothetical director.

The above will lead to my following chapters, with chapter three dedicated to explore critically the traditional justifications for judicial/legislated deference; and chapters 4, 5 and 6 which will be respectively dedicated to the research of the significance of creativity in the context of the company's business and judicial deference from a psychology perspective; types of business decisions for the justification of application or non-application of judicial/legislated deference (for instance, business judgment vs directorial responsibility on internal control); and how my proposed system that specifically focus on 'motivation' and 'creativity' operates within the enforcement stage of derivative claim.

With the end result, this research aims to demonstrate a better understanding and enhancement of the justification for company law's deference under the enforcement stage of derivative claim, by demonstrating the operation of the law based on the mechanism involving my proposed types of business decisions.

CONCLUSION

This chapter has discussed the judicial deference within the British legal system in the context of company directors' business decisions relating to the pre and post Companies Act 2006 eras.

The judicial interference has taken place in the matters relating to directors' duties in supervision or internal control. However, judicial deference remains constantly applicable in the matters relating to directors' business judgment.

With regards to derivative actions initiated by company shareholders, judicial deference insulating company directors from liability in the context of their business decision has been in existence within the British common law for over a century. There was almost no limitation as to the extent of the judicial deference, as derivative actions brought by shareholders of the company against company directors were mostly and practically not actionable. With the exception of the situation where the director in question retains majority control of the company; and that the directors had obtained personal interest as a result of their "majority control" from the transaction. The courts' diffidence to interfere with the company's management was based on the bona fide business judgment exercised by an appropriate independent organ of and in the interest of the company.

The rule of wrongdoer's control was abolished by Part 11 of the Companies Act 2006. Derivative claim is now also available to company members acting, in good faith,

without having to satisfy the fraud on minority on the part of the board. However, this does not lead to the extinction of judicial deference. The current extent of the deference legislated by the Act, signifies a departure from the traditional wrongdoer's control rule/fraud on minority, and substitutes it with a deference embodied by a more sophisticated rule. In other words, shareholders who initiate the claim has to satisfy the hypothetical director test within the provision of Sections 263(2)(a) and 263(3)(b) under which the shareholders would have to convince the court that based on Section 172, the hypothetical director would continue the derivative claim in good faith and in the interest of the company. From this perspective, one can see that the statute retains the common law principle laid down in the cases such as *Taylor v. National Union of Mineworkers (Derbyshire Area)*,[287] whereby the directors' decision not to sue was not deemed a fraud on minority, provided the decision not to sue was taken, in good faith, and for the benefit of the company. Whilst the legislation continues to preserve the common law principle of respecting the managerial discretion of directors, acting as an appropriate independent organ of the company, the new law provides the judges with a 'space' to identify the type of business decisions that are of creative nature (which is in line with business judgments as described by the judge in *Overend & Gurney v. Gibb*[288]*)* that justify legislated deference. Consequently, this list of factors that judges would consider to be in the interest of the company is now non-exhaustive. It follows that Part 11 of the 2006 Act reveals that legislated deference on matters of

[287] [1985] BCLC 237 (HC) 255
[288] [1872] LR 5 (HL) 580

bona fide business judgment exercised by appropriate independent organ, in the interest of the company still operates within the Act. This thesis will demonstrate the justifications of British judicial and legislated deference, from perspectives of psychology; management and economics aspects of creativity. This thesis will lead up to the clarification of the availability of judicial or legislated deference determined by the types of business decision with creativity being the central factor.

Unlike judicial deference relating to the matters of business judgment/Non-Programmed (Creative) Business Decisions,[289] the standard of conduct (a test representing a judicial benchmark in which judges can assess the scope of directors' duties in determining negligence) relating to the issue of internal control, oversight and the continuing possession of the relevant business skills has been the subject of debate and development in common law. The legal development being seen to be divided into pre-1990s and post-1990s with the court shifting from a judicial deference based on a passively low and modest legal expectation of skill and care based on a subjective test to a much more stringent approach through the introduction of the dual (objective and subjective) standard of care. Directors are now expected to be active as well as possessing the relevant skills in the company's business. This in effect leads to the extinction of judicial deference in the context of internal control and supervision.

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[289] (n127)

As the position of Section 174 Companies Act 2006 represents a codification of the common law approach; therefore, it is safe to conclude that judicial deference in the context of internal control, supervision and possession of the relevant skill for the company's business remains extinct.

In the next chapter, the focus will be on the justification of judicial or legislated deference based on the traditional factor known as "judges are not business experts" or "judges are ill-equipped" to assess company directors' business judgment. Linking the discussion of its true meaning to company directors' business creativity.

CHAPTER THREE - JUDGES ARE NOT BUSINESS EXPERTS – A CONVENIENT MISUNDERSTANDING

CHAPTER INTRODUCTION

In Chapter Two, I established that (in the same way as American business judgment rule) the UK judicial deference exists in the context of company directors' negligence relating to their business judgment. I have also pointed out that the justification given by the judges to back up this deferential policy on the ground that UK courts are not commercially trained to judge business judgments (as coined by this thesis, from a psychology perspective, Non-Programmed (Creative) Business Decisions). Chapter Two, therefore, raises an interesting question, i.e., how does the argument based on judges' business expertise actually represent the justification? In other words, when the judge said that he is not a business expert or commercially equipped to deal with director's business judgment, does such a statement refer to the business expertise of the judges or the directors' business creativity irrespective of the availability of the judges' business expertise?

This Chapter aims to critically examine the main argument known as 'judges are not business experts' traditionally raised by the academic writers, such as Bainbridge;[290] and judges in the American and the British cases (seemingly implied) respectively.

[290] Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 83

For instance, *Dodge v. Ford Motor Co*[291] and *Iesini v. Westrip Holdings Ltd*[292] in favour of company law's deference to protect the directors' business decisions.

My **overall objective** of this Chapter is to adopt a doctrinal approach by demonstrating that the issue of judges' business expertise has been a long-standing misconception amongst the academics and practitioners, as the justification of the judicial and legislated deference. I will also adopt normative approach by critically examining the law's relevant value position, i.e., that when judges' refused to second-guess directors' business decisions on the ground that, as judges, they were/are not business experts or commercially equipped to interfere with those business decisions, the relevant justifications were based on the directors' Non-Programmed (Creative) Business Decisions (a type of business decision that is not bound by any predefined rule (as fully discussed in Chapter Five); and satisfies the psychology definition of creativity (as set out in Chapter Four of this thesis).

The following provides greater detailed information in relation to the steps taken to achieve the objective:

The argument to be discussed in this chapter is primarily based on the suitability of judges to judicially review company directors' business decisions. In doing so, the research is conducted from a perspective on whether or not judges need to be business

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[291] [1919] 170 NW 668, 684
[292] [2009] BCC 420 (Ch) [85]

experts as a pre-requisite condition ('the Traditional Factor') for dealing with the relevant cases.

Arguments and analysis will be presented to reveal that the Traditional Factor is based on a number of faulty assumptions the academic writers such as Bainbridge and Davis.[293] To reveal the true meaning of the Traditional Factor as a factor in support of judicial or legislated deference, this chapter will introduce the factor based on the business creativity in the form of types of decision taken by company directors. This will connectively lead to the system as concluded in Chapter Two, whereby, both US and UK judges will selectively apply judicial or legislated deference on derivative claims against ordinary negligence based on whether or not the business decision in question was Non-Programmed (Creative) Business Decision.

This Chapter will demonstrate that the judicial system, in reality, does not suffer from shortage of business expertise due to the availability of business expert judges or business expert witnesses. The chapter will move on to discuss the existing counter-argument against judicial or legislated deference based on non-directorial professions. This would lead to the understanding of the difference of the types of decisions made between company directorship and other professions. The aim of this exercise is to support the justification of judicial or legislated deference exclusively in

[293] Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 83, 117 – Bainbridge focused his discussion on writers such as Davis' interpretation on the factor relating to judges' business expertise; and Kenneth B Davis, Jr, 'Once More Business Judgment Rule' (2000) Wis Law Rev 573

favour of a person acting in the capacity of a company director on the ground of business creativity. In other words, this will set out the foundation identifying the difference between non-directorial professions and company directors in terms of the nature of their decisions. Namely, the decisions that can be assessed by a predefined protocol (with sufficient degree of business expertise); and the decisions that are creative in nature which cannot be assessed by any predefined protocol, thus rendering the question of business expertise capacity immaterial.

In addition, this Chapter will normatively demonstrate that the psychology theory of bounded rationality can be used to support the traditional justification of judicial or legislated deference – 'judges are not business experts' from the perspective of directors' Non-Programmed (Creative) Business Decisions. In other words, judges or business expert witnesses are more boundedly rational than company directors within the context of Non-Programmed (Creative) Business Decision-making for companies. This is because company directors have better access to business connection or resources such as the close commercial relationship with other companies; and control of the company's assets. In addition, directors are not subject to the time-constrain of the judicial system, as opposed to judges, in their business decision-making process. These elements mean that company directors are better motivated and better equipped to make Non-Programmed (Creative) Business Decisions in the interest of the

company than business expert judges (who are, in the absence of judicial or legislated deference, to second-guess the business decisions).[294]

This chapter will conclude that some writers including Davis[295] & Bainbridge[296] have misidentified the shortage of business expertise within the judicial system for directors' business creativity as the justification for judicial or legislated deference. This Chapter will conclude that when the judges said that they were not business experts; or that they were not commercially equipped to interfere with the decisions of the directors, they meant that they were not physically[297] and psychologically[298] equipped to second guess the Non-Programmed (Creative) Business Decisions of the directors.

This chapter paves the way to allow this thesis, by way of Chapter Four and Five, to examine judicial or legislated deference from a perspective of psychology (in creativity, motivation and types of business decisions) and demonstrate that the company law's deference motivates company directors' business creativity.

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[294] The psychology concept of motivation is closely linked to business creativity and both will be dealt with in full details in Chapter Four.

[295] (n 294)

[296] ibid

[297] The absence of pre-defined benchmark to assess the Non-Programmed (Creative) Business Decisions renders the availability of business expertise in the judicial system immaterial.

[298] More boundedly rational than company directors resulted in less motivation to second-guess the Non-Programmed Business Decisions.

It should be noted that for the purpose of this Chapter (and throughout this thesis) the term **Non-Programmed (Creative) Business Decision** is used interchangeably with the term – **business judgment**.

THE TRADITIONAL FACTOR – 'JUDGES ARE NOT BUSINESS EXPERT'

This section is to discuss the Traditional Factor used by the judges in both UK and US jurisdiction supporting judicial deference. The purpose of this section is to first enable the readers to understand the background of the Traditional Factor. Once the background is introduced, I will present my own analysis to demonstrate that the Traditional factors actually refers to the business creativity of the directors, as opposed to the questioning of the amount of business expertise within the judicial system to assess the business decisions of the directors.

'Judges are not business experts'[299] represents one of the most famously quoted Traditional Factor by academic writers Davis & Bainbridge;[300] and judges applying the business judgment rule. This Traditional Factor was explicitly given by the judge of Michigan Supreme Court in the case of *Dodge v. Ford Motor Co* as a ground

[299] Kenneth B Davis, Jr, 'Once More Business Judgment Rule' (2000) Wis Law Rev 573, 580
[300] Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 83, 117

justifying judicial deference to the business decision made by Henry Ford[301] - the then director of Ford car manufacturing company.

In his judgment, the judge further commented that, the fact that a business plan can be so sophisticated that:

> We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company. In view of the fact that the selling price of products may be increased at any time. The ultimate results of the larger business cannot be certainly estimated – The judges are not business experts.[302]

The judge commented that the business plan, 'must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture.'[303] In other words, the judge meant that the business judgment is therefore, best to be left to the directors of the company who are more experienced in the

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[301] (Mich. 1919) 170 NW 668, 684 as cited by Robert Hamilton, *Corporations including Partnership and Limited Partnership, Cases and Materials* (2nd edn, West Academic Press (1981)) 816. This was also cited in Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 83, 117); See also Anne Scarlett, 'Confusion and Unpredictability In Shareholder Derivative Litigation: The Delaware Court's Response to Recent Corporate Scandals' (2008) Fla L Rev 589, 600 as cited by Legg and Jordan 'The Australian Business Judgment Rule after *Asic v. Rich*: Balancing Director Authority and Accountability' (2014) 34 Adel L Rev 404, 410; See also Andre Tunc 'The Judge and the Businessman' (1986) Law Q Rev Vol 102 549, 554

[302] *Dodge v. Ford Motor Co* 170 NW 668, 684 [Mich. 1919] Rule 702 Federal Rule of Evidence 2001 defines and expert as a person with 'scientific, technical or other specialized knowledge'; Cambridge Dictionary as 'A person with high level of knowledge or skill relating to a particular subject or activity' Cambridge Dictionary http://dictionary.cambridge.org/dictionary/english/expert?q=expert+ accessed 10th September 2017; or by the definition of the Expert Witness Institute (EWI) UK as ' the expert is anyone with specialist knowledge not commonly held, or likely to be understood by a layman' EWI http://www.ewi.org.uk/membership_directory_why_join_ewi/whatisanexpertwitness accessed June 2017; and see also definition of expert witness in para. 1.4.4.

[303] *Dodge v. Ford Motor Co* 170 NW 668, 684 [Mich. 1919]

corporation's business than the judges who are bound by the judicial paradigm. Judges are therefore, subject to 'more rigid training, more closely structured environment'[304] than company directors.[305] Looking at the issue from a slightly different perspective, we can summarily say that directors' day-to-day business practice with their commercial experience being developed (in the context of the business world) makes them more suitable to make business decisions for the company (as in line with the statement of the judge in *The Overend Gursey Co v. Gibb*[306]). In view of this, I will argue that the term, 'judges are not business experts' should not be taken at its literal meaning referring to the insufficiency of the amount of business expertise in the judicial system. Rather, it is the rigidity of the judicial system that prevents judges being less business creative than company directors. Judicial deference in this context is exercised by the judge in favour of the director, with the exception of the directors' breach of duty of care that is so blatantly incompetent to a point that it does not require a business expert to evaluate the case.[307]

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[304] Kirton and Pender, 'The Adaption-Innovation Continuum. Occupational Type, and Course Selection' *(1982)* Psychol Rep Vol 51, 883 *as cited by Woodman et al,* 'Toward A Theory of Organizational Creativity' *(1993)* Acad of Manag Rev Vol 18 No.2 293, 305

[305] Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 83, 117. See Chapter Four for greater discussion on the judicial limitation from a psychology perspective.

[306] [1872] LR 5 (HL) 480, 495 as cited Marc Moore, *Corporate Governance in the Shadow of the State* (Hart Publishing 2013) 155

[307] Melvin A. Eisenberg, 'The Duty of Care of Corporate Directors and Officers' (1989-1990) 51 U Pitt L Rev 945, 969

Following the latest part of the above paragraph that relates to directors' obvious incompetency or gross negligence, a quick citing of examples of judicial interventions on directors' business decisions, whereby the clarity of these cases present themselves are self-explanatory. These include the cases, for instance,the company director executed on behalf of the company an insurance form without first reading its content (*Re D'Jan of London Ltd*[308]); or the director made a completely uninformed decision leading to the substantial breach of directors' duties in supervision (*re Baring Plc and Others (No. 5)*[309]). This view that judicial intervention would take place in a clear case relating to the gross incompetence of the director is also explicitly shared by another UK judge – Lewison J, in *Iesini v. Westrip Holdings Ltd.* Consequently, this case led to the conclusion in support of judicial deference relating to directors' business judgment by way of section 263(3)(b) Companies Act 2006 where there is a strong case supporting deference but not 100% conclusive.[310] A corresponding US law case, whereby the director of a targeted company in a leveraged buy-out merger accepted a proposed sale price at an undervalue without having any prior consultation with any relevant financial experts to determine the actual value of the company. Consequently,

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[308] [1994] 1 BCLC 561 (Ch)

[309] [1999] 1 BCLC 433 (Ch); Kershaw, Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 428; Tamo Zwinge, 'An Analysis of Duty of Care in the United Kingdom in Comparison with the German Duty of Care' *(*2011) ICCLR 31, 32

[310] [2009] BCC 420, (Ch) [85]

the court found the director grossly negligent; and allowed judicial intervention i.e., the director was not protected by business judgment rule (*Smith v. Van Gorkam*[311]).

The decisions to insulate directors from negligence liability have been upheld by judges in a number of cases across both the UK and the US judicial spectrum. The substance of the justification for the legislated or judicial deference, appeared or *prima facie* to be the Traditional Factor questioning the availability of business expertise in the judicial system. For instance, in the UK, Lewison J's approach to refuse to interfere with the director's decision under section 236(2)(a), on the basis of the court being 'ill-equipped' to get itself to deal with the director's business decision. This decision was subsequently affirmed by the judge in *Stimpson v Southern Landlords Association*.[312] In the US, in *Kamin v. American Express Co*[313] where the plaintiff shareholders brought a negligence action against the company director who had made the business decision to forfeit massive tax saving, as a result of their refusal to distribute dividends. The court ruled that the directors were entitled to the protection of the business judgment rule - 'The directors' room rather than the courtroom is the **appropriate** forum for thrashing out purely business decisions

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[311] *Smith v. Van Gorkom* 488 A 2d 858 [Del. 1985]

[312] [2010] BCC 387 (Ch) as cited in the case comment 'Stimpson v Southern Landlords Association: Permission to Continue Derivative Claim Refused' (2010) Co Law 277, 283-284; see also Tang, 'Shareholders' Remedies: Demise of the Derivative Claim?' (2012) UCL 182

[313] 383 NYS 2^{d} 807 Supreme Court [1976]

which will have an impact of on profits, market prices, competitive situations or tax advantages.'[314]

Three years after *Kamin*, the judges took the similar view in *Auerbach v. Bennett.* The Judge commented, 'the responsibility for business judgments must rest with corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility.'[315] To support this view, the judge in *Solash v. Telex Corp* also said, 'Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts … courts have long been reluctant to second guess such decisions when they appear to have been made in good faith.'[316]

On the UK side, apart from *Iesini v. Westrip Holdings Ltd* as mentioned above, other cases throughout the pre-2006 Act and post-2006 Act period, such as the *Overend Gurney & Co v. Gibb*;[317] *Howard Smith Ltd v. Ampol Petroleum Ltd*;[318] *Allen v. Gold Reefs of West Africa Ltd*;[319] *Smith v Croft (No. 2)*;[320] *Extrasure Travel Insurances Limited v. Scattergood and Others*;[321] and *Wishart v Castlecroft Securities Ltd*[322] are

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[314] 383 NYS 2d 807 Supreme Court [1976] as cited by Stephen M. Bainbridge in 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 98, 117

[315] [1979] NYS 393 N.E. 2d 994, 1000 as cited by Kenneth B. David, JR, 'Once More, The Business Judgment Rule' (2000) WIS L Rev 573, 580

[316] [1988] (Del CH) 13 Del. J. CORP. L. 1250, 1262 as cited by Kenneth B. David, JR, 'Once More, The Business Judgment Rule' *(2000)* WIS L Rev 573, 580

[317] [1872] LR 5 (HL) 580

[318] [1974] UKPC 3 (PC)

[319] [1990] 1 CH 656 (CA)

[320] [1988] CH 114 (Ch)

[321] [2002] BCLC 598 (Ch)

cases where judges have all (if not amongst other non-commercial reasons – see for instance, the judges quoting in *Kleanthous v. Paphitis* the principles in *Wishart v Castlecroft Securities Ltd* (see ft 323 below)) refused to second-guess the business decision of the company. These were so, not just to preserve the decision-making power of the appropriate independent organ of the company, but also on the basis that the judges were simply not equipped to interfere with the business decision of the company. This judicial diffidence in dealing with directors' business resulted in only requiring the directors to satisfy good faith on subjective basis.

It is interesting to note that whilst the UK judges have reached a similar conclusion on being diffident in interfering with directors' decision that were regarded as business judgment, they were less explicit (as opposed to the American judges) as to how or where this judicial incompetence comes from.

To look at the similarity of the expression used by both the UK and the US judges, the academic writer Gibbs said that that the judge was not equipped to get himself involved in considering the commercial factors and would therefore, prefer to stay within the confinement of the law than within the commercial realm in deciding whether or not a hypothetical director would continue the action. This demonstrated

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[322] [2009] CSIH 63 (ED) [37] as cited by Newey J in *Kleanthous v. Paphitis* [2011] EWHC 2287 (Ch) [71], [72] & [73]. Note: the judge's decision to discontinue the claim in *Kleanthous v. Paphitiswas* was not solely attributed to judges being unequipped to deal with the directors' commercial decision, it was also based on other non-commercial decision factors such as availability of alternative remedies, i.e., unfair prejudice; and that the distribution of the money would end up being returned to the defendant directors anyway.

that, 'there was no breach of duty and where it was impossible to say whether there was negligence.'[323] In other words, one is tempted to infer that whilst the term 'judges are not business experts' were not specifically used by the judges in the UK, the judges were diffident in interfering with directors' business judgment because they did not view themselves as business or commercial experts. Arguments will be presented in the latter part of this chapter that, in reality, the judges, instead of viewing themselves as not being business experts, they viewed themselves as being less business creative than company directors.

Going back to the case of *Dodge v. Ford Motor Co*,[324] according to the judge, an example of judicial deference based on 'judges are not business experts' can be demonstrated in the situation, where a long-term business plan can be so sophisticated that involved elements of uncertainty. These elements of uncertainty resulted in a non-business expert judge to fail to recognize that the business plan had been formulated to achieve the success of the company's business in the long-term at the expense of dividends payments to the shareholders in the short-term.

This can be demonstrated in a typical business example where the company director decides to invest the profits to increase the number of new plants as a result of the director's business judgment expecting an increase of demand for the company's

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[323] Gibb, 'Has the Statutory Derivative Claim fulfilled its Objectives? A Prima Facie Case and the Mandatory bar: Part 1' (2011) Co Law *43*

[324] [1919] 170 NW 668, 684

products in the foreseeable future. This investment is done at the expense of the shareholders' dividends. To put it simply – long-termism trumps short-termism.

BOUNDED RATIONALITY

The above section introduces the background of the Traditional Factor, i.e., 'judges are not business experts'. In this part, I will concentrate my discussion on the nature of bounded rationality that relates to judges who are to deal with directors' business decisions; and how the theory **supposedly** relates to the Traditional Factor, 'judges are not business experts'.

From an economic point of view, the factor that 'judges are not business expert' has been commonly linked to 'bounded rationality',[325] a theory originally proposed by the psychology researcher - Herbert A. Simon, as a basis for mathematical modeling of decision-making.[326]

The theory of 'bounded rationality' describes, 'the inherent limits on the ability of decision makers to gather and process information'[327]. In other words, the rationality

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[325] Oliver E. Williamson, *The Economic Institution of Capitalism* (The Free Press 1985) 45, 46 as cited by Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004)) 57 Vand L Rev 83, 118; see also Jeffrey Rachlinski, 'The Uncertain Psychological Case for Paternalism' (2003) NWU L Rev 1168

[326] See generally H.A. Simon, *Models of Bounded Rationality*, *Volume 1, Economic Analysis and Public Policy* (MIT Press 1982) 235; see also generally, M. Conant, 'The Anti-trust Per Se Rule: Judicial Decision-Making Under 'Bounded Rationality' (1980) L & E Con Rev 49

[327] See generally Paul Milgrom & John Roberts, *Economics, Organization and Management* (Pearson 1992) 127-129 defining the concept mostly by examples as cited in Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 118. See also generally, Jon

of an individual is subject to and applied after the limitation plus uncertainty of resources/conditions physically and cognitively. This is known as human limitations,[328] for instance, humans are subject to limited memory and time. Thus, are prone to seek to maximize convenience by way of mental and physical shortcut to suit the decision maker's self-interest.[329] From this point of view, the decision maker is termed as 'the satisficer', i.e., someone who seeks a satisfactory solution to serve the decision maker's self-interests, instead of an optimal solution for the actual circumstance or problem.[330]

In other words, without being in the actual circumstances of the resources and the risk, one can no longer be able to reach a decision that represent his or her genuine preference in the actual circumstances despite being given an advanced warning.

Elster, *Sour Grapes: Studies in the Subversion of Rationality* (3rd edn, Cambridge University Press October 1983)

[328] See for example, Adrian Vermeule, *Judging under Uncertainty: An Institutional Theory of Legal* (Harvard University Press 2006) 155

[329] Mental shortcut is also described as heuristics, i.e., "a procedure for problem solving that functions by reducing the number of possible alternatives & solutions & thereby increase the chance of solution." A. Lewis, *The Cambridge Handbook of Psychology and Economic Behaviour* (Cambridge University Press 2008) 43. Example of Heuristics would be that people tend to associate higher price with better quality and therefore, without having going into a thorough research, decision makers would be tempted to think that an item of higher price is of better quality than the others when in fact this might well not be true. Heuristics can sometimes be useful but runs the danger of reaching a different decision had the decision maker being given full information - A. Tversky & D. Kahneman, 'Judgment under uncertainty: Heuristics and Biases' (1974) Vol 185 Science 1124, 1130; G. Gigenrenzer et al, '*Fast & Frugal Heuristics: The Tool of Bounded Rationality' (2004)* 65 <http://library.mpib-berlin.mpg.de/ft/rh/RH_Fast_2009.pdf> last accessed 20 May 2017 ; C. Jolls and C. R. Sunstein, *'Debiasing Through Law' The Journal Of Legal Studies*' (2006) Vol 35 (1) 199-241; and 199, 203-206; see also C. R. Sunstein, 'What's Available? Social Influences and Behavioral Economics' (2003) 97 Nw U L Rev 1295, 1312

[330] Gigerenzer, Gerd, Selte and, Reinhard, *Bounded Rationality: The Adaptive Toolbox* (MIT Press, 2002) 14

The assumption that humans are rational entities who are always able to make perfectly rational decisions have therefore, long been refuted by the concept of bounded rationality.[331] As stated by Paul Slovic, the psychology professor, ' … a revealed preference approach assumes that people not only have full information, but also can use that information optimally, an assumption that seems quite doubtful in the light of much research on the psychology of decision making.[332] '

It follows that, a bounded rational decision maker would be unlikely to effectively assess the situation and reach a rational decision, '… under the conditions of uncertainty and complexity, it becomes very costly and perhaps impossible, to describe the complete decision tree.'[333] Empirical studies have shown that bounded rational decision makers have the tendency to minimize the efforts in reaching a proper decision when they face the conditions of uncertainty and complexity.[334] For instance, the academic writers such Hagle, who has pointed out that it had been

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[331] See Gigerenzer, Gerd, Selten and Reinhard, *Bounded Rationality: The Adaptive Toolbox* (Cambridge (MIT Press 2002) 14

[332] Paul Slovic, *The Perception of Risk* (re-print Ed, Earthscan Publications 2000) 82

[333] Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (Free Press 1975) 23 as cited in Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 118. See also generally Hagle, Timothy M. 'So Many Cases, So Little Time: Judges as Decision Makers' (1990) < https://www.researchgate.net/publication/44208624_So_Many_Cases_So_Little_Time_Judges_as_Decision-makers > accessed June 2017; and Ed. Douglas Madsen, Arthur H. Miller, and James A. Stimson. Dubuque, Iowa: Kendall/Hunt, In *American Politics in the Heartland* (Kendall Hunt Pub Co 1991) 1

[334] See generally Hagle, Timothy M, 'So Many Cases, So Little Time: Judges as Decision Makers' (1990) <https://www.researchgate.net/publication/44208624_So_Many_Cases_So_Little_Time_Judges_as_Decision-makers > accessed June 2016; and Ed. Douglas Madsen, Arthur H. Miller, and James A. Stimson. Dubuque, Iowa, In *American Politics in the Heartland* (Kendall Hunt Pub Co 1991) 1. See generally Edward Tsang, *'Computational Intelligence Determines Effective Rationality'* (2008) IJAAC 63–66

reported that judges suffer the tendency of over-reliance on judicial precedents as a way of 'mental shortcut' in dealing with law cases irrespective of the degree of the relevancy of the judicial precedents to the cases.[335]

Other than Hagle, Bainbridge & Gulati; and Langlaise have also pointed out that judicial decision makers are no exception to the limitations of bounded rationality.[336] Schauer;[337] Gluti and Bainbridge[338] have argued that this is **further reinforced** by the agency cost economics. An agency cost is:

> **…** economic concept concerning the cost to a 'principal' (an organization, person or group of persons), when the principal chooses or hires an 'agent' to act on its behalf. Because the two parties have different interests and the agent who has the access to and control of more relevant information, the principal

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[335] See generally Hagle, Timothy M, 'So Many Cases, So Little Time: Judges as Decision Makers' (1990) <https://www.researchgate.net/publication/44208624_So_Many_Cases_So_Little_Time_Judges_as_Decision-makers > accessed June 1026

[336] E. Langlais, 'An Analysis of Bounded Rationality in Judicial Litigations: The Case with Loss/Disappointment Averse Plaintiffs' (2010) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id, ' … Cognitive biases are also exhibited by well experienced lawyers and judges.', 1. > Accessed 2015; see also generally, Gulati & Bainbridge, 'How do Judges Maximise? (the Same Way Everybody Does – Boundedly) Rules of Thumb in Securities Fraud Opinions' (2002) EMORY LJ 83

[337] F. Schauer, 'Incentives, Reputation and the Inglorious Determinants of Judicial Behaviour' (1999) 68 U CIN L Rev 615 as cited by Gulati & Bainbridge, 'How do Judges Maximise? (the Same Way Everybody Does – Boundedly) Rules of Thumb in Securities Fraud Opinions' (2002) EMORY LJ 83

[338] Gulati & Bainbridge, 'How do Judges Maximise? (the Same Way Everybody Does – Boundedly) Rules of Thumb in Securities Fraud Opinions' (2002) EMORY LJ 83; and Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 118

cannot directly ensure that its agent is always acting in its (the principals') best interests.[339]

In this context, it is arguable that the UK courts can be said to be the agents of the law. This can be observed when judges sworn the judicial oaths, the judge '… has acknowledged that he or she is primarily accountable to the law which he or she must administer. This involves putting aside private interests and preferences and being alert to attempts to influence decisions or curry flavour';[340] and 'The primary responsibility for deciding whether a particular activity or course of conduct is appropriate rests with the individual Justice. The interests of justice must always be the overriding factor.'[341] Being an agent of the law, in practice, can be influenced by the external constraints, for instance, the institutional constraint of adjudication system.[342] Bainbridge have specifically argued that it would relate to the interest of judges to speed up the trial process[343] because if judicial intervention 'were employed

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[339] Lucian Bebchuk and Jesse Fried, *Pay Without Performance* (Harvard University Press 2004) (Preface and Introduction); The term 'the agency cost economics' was also cited by Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 118

[340] See The Supreme Court, 'Guide to Judicial Conduct and Complaints' (2 January 2019) < https://www.supremecourt.uk/about/judicial-conduct-and-complaints.html> accessed 15 January 2019

[341] ibid

[342] Julian Velasco, 'Structural Bias and the Need for Substantive Review' (2004) Wash U L Rev Vol 82 821, 839

[343] Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 118; See also generally, Chancery Guide <www.chba.org.uk/for-members/library/.../chancery-guide-updated-october-2013> October 2013 accessed in 2013

too frequently, it would consume a great deal of judicial resources'.[344] In other words, judges would be overloaded with cases.

Academic writer Andrew S. Gold is in agreement on the idea that judges can be adversely affected by agency cost and bounded rationality. He has expressed his view relating to the scenario that when making judicial determinations, judges are limited by substantial institutional constraint and thus, judges can easily succumb to bounded rationality. As a result, for difficult institutional choices, such as the institutional capacities, decision cost and other effects within the judicial system, 'judges are unable to put value to the variables that institutional analysis identifies as relevant.'[345] Gold further argued that humans' cognitive biases can also be contributing to adjudicative process, therefore, when information is available on one variables as opposed to the other, judges who are subjected to the institutional constrains would inevitably put too much weight for one variable against the other which can lead to judicial error. 'And courts may be in a poor position to discover after the fact...'[346] as they are confined in required institutional options.[347]

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[344] Julian Velasco, 'Structural Bias and the Need for Substantive Review' (2004) Wash U L Rev Vol 82 821, 839

[345] DEL CODE ANN. TIT. 8, s102(B)(7) (REPL. VOL. 2001) as cited by Andrew S. Gold, 'A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith and Judicial Uncertainty' *(2007)* Mary L Rev Vol 66 398-474, 453-454

[346] Andrew S. Gold, 'A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith and Judicial Uncertainty' (2007) Mary L Rev Vol 66 398-474, 454

[347] Andrew S. Gold, 'A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith and Judicial Uncertainty' (2007) Mary L Rev Vol 66 398-474, 453-454

Consequently, judges are more likely to succumb to limitations of bounded rationality when assessing a company business decision as opposed to company directors. In other words, cognitively, judges can be said to be de-motivated by the institutional constraint. On the other hand, directors are not subject to the institutional constraint of the judicial system, therefore, are relatively less boundedly rational than judges.[348]

Looking at the comparison of resources possessed between judges and directors, when making business decisions for the company, the argument has been specifically expanded by academic writers such as Conard. Conard pointed out the problem that judges tend to decide cases alone,[349] whereas directors typically operate within a board collectively with their research being relatively easier to be outsourced. This means that directors (as opposed to judges) tend to form a team for dealing with the company's tasks and thus, bringing a wide range of different sets of business expertise, business assets and business connection into the decisionmaking process.[350] In other words, directors tend to possess comparatively more company experience and

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[348] Kirton and Pender, 'The Adaption-Innovation Continuum. Occupational Type, and Course Selection' (1982) Psychol Rep Vol 51 883 as cited by Woodman et al, 'Toward A Theory of Organizational Creativity' (1993) Acad Manag Rev Vol 18 No 2 293, 305. Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisations' (1988) Res Organ Behav Vol 10 167. See Chapter Four for detailed analysis of motivation affecting the level of a person's bounded rationality.

[349] This might not be true as judges decide complicated business cases with the assistance of the expert witnesses. Canard's statement regarding judges deciding 'cases alone' is contrary to the core of this chapter which argues that judges do not suffer from the lack of business expertise. But judges are not and are not meant to second-guess business creativity of company directors irrespective the amount of business expertise at their disposal.

[350] Alfred A. Conard, 'A Behavioural Analysis of Directors' Liability for Negligence' (1972) Duke L J 895, 906

relevant resources that are all essential in assisting an individual to reach a proper business decision for the company.

In the later part of this Chapter, I will argue (to a certain degree opposing Conard's view above) that judges do not suffer from lacking business expertise due to the stringent selection of judges and the availability of expert witnesses at the judiciary's disposal.

BOUNDED RATIONALITY AS AN ENFORCEMENT OF THE TRADITIONAL FACTOR

The above section introduces the psychology theory of bounded rationality. The objective of this section is to explain purely from the traditional perspective the inter-relationship between the Traditional Factor and the theory of bounded rationality to give an in-depth background of how the Traditional Factor being fully used to justify judicial deference. This section would serve as an introduction for the immediate following section, aiming not just to demonstrate that the Traditional factor was a reference to the directors' Non-Programmed (Creative) Business Decisions, but also enables me to demonstrate the inter-relationship between directors' business creativity and bounded rationality within the understanding of the Traditional Factor.

Going back to the Traditional Factor that judges are not business experts. The theory of bounded rationality has been used as an argument to reinforce the factor that judges

in general are not suitable in dealing with directors' business decisions. For instance, the court in the case of *Shlensky v. Wrigley* acknowledged judges are generalists and not experts in business, and that they possess limited knowledge in running the defendant's company's business.[351] As a result of the limitation in business knowledge, non-business expert judges are boundedly rational. Eric A. Posner has said the following regarding some of the American judges:

Courts have trouble understanding the simplest business relationship. This is not surprising. Judges must be generalists, but they usually have the narrower backgrounds in a particular field of law … Their frequent failure to understand transactions is well documented. One survey of cases involving consumer credit, for example, showed that the judges did not even understand the concept of present value … Skeptism about the quality of judicial decision making is reflected in many legal doctrines, including the business judgment rule in corporation law, which retrains court from second-guessing managers and directors …[352]

American writer Gilmore has also pointed out the limitation severely faced by judges:

> The facts underlying a transaction or business practice or a social custom can be a glimpsed in judicial opinion only as a glass darkly. The courts themselves

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[351] 237 NE 2n, 780 [III. App. 1968] as cited in Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 119

[352] Eric A. Posner, 'A Theory of Contract Law Under Conditions of Radical Judicial Error' (2000) 94 NW UL REV 749, 758; *Shlensky v Wrigley* 237 NE 2n, 780 [III. App. 1968] as cited in Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 119-120; & Stephen M. Bainbridge, *The New Corporate Governance in Theory and Practice* (OUP USA 2008) Chap. 3 , 121

> burdened by judicial procedural limitation and restricted to adversary proceedings are poor institutions for finding out what the essential facts are or were … thus the inadequate judicial techniques make judicial opinion worthless as accounts of what is actually going on in the world.[353]

The view that judges are limited by bounded rationality due to lacking of business expertise has once again been re-affirmed by Vice-Chancellor Glasscock in his Memorandum Opinion in more recent Delaware case of *Re Goldman Sachs Group, Inc. Shareholder Litigation*:

> So long as such individuals act within the boundaries of their fiduciary duties, judges are ill-suited by training (and should be disinclined by temperament) to second-guess the business decisions of those chosen by the stockholders to fulfill precisely that function.[354]

As the above claimed, many judges (across many legal jurisdictions, including the US or the UK)[355] are not experts in many fields, including company business. This adds to the notion that when making a judicial decision, judges often need to be guided by the relevant expert witnesses, for instance, accounting experts or financial experts in

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[353] G. Gilmore, The Ages of American Law (Yale University Press, 1977) 88 as cited by M. Conant, 'The Antitrust Per Se Rule: Judicial Decision Making Under Bounded Rationality' [1980] L Econ Rev 53

[354] [2011] CA No 5215-VCG, 1-2 [Del CH 2011] (cited also in Stephen M. Bainbridge's recent article, 'Judges Are not Business Experts, But So What?' (2011) www.ProfessorBainbridge.com> accessed 2nd June 2015

[355] See for example, In *Overend Gursey & Co v. Gibb* [1872] LR 5 (HL) 580, 495 and *RE Brazilian Rubber Plantations and Estate* [1911] AC 477 (HL) 488 both cited by Marc Moore, *Corporate Govenance in the Shadow of State* (Hart Publishing 2013) 155

the fields of auditing and finance respectively (for example, judges using an auditor as an expert witness in the case of *Smith v. Croft*[356]).

An expert witness is 'a person who is a specialist in the subject, often technical, who may present his/her expert opinion without having being a witness to any occurrence relating to any lawsuit...'[357] And the duty of expert witnesses is to 'help the court on matters within their expertise'.[358]

In the following section, I shall demonstrate that, contrary to the traditional understanding of the terms "judges are not business exerts" and "…judges are ill-equipped …" as a reference to the business expertise available within the judicial system, the true meaning of the terms actually refers to the directors' business creativity irrespective of the availability of the judges' business expertise.

JUDGES ARE NOT BUSINESS EXPERTS VS. DIRECTORS' MOTIVATION AND CREATIVITY

In this part, I will argue that if the Traditional factor 'judges are not business experts' is referring to the understanding of availability of the amount of business expertise within the judicial system. Such an understanding will be based on a number

[356] [1986] 1 WLR 580 as cited by Boyle, 'The Judicial Review of the Special Committee: the Implications for the English Derivative Action after *Smith v. Croft*' (1990) Com Law 3

[357] The Free Dictionary.com < http://legal-dictionary.thefreedictionary.com/expert+witness> accessed 2nd July 2017.

[358] Civil Procedure Rules 35.3

of faulty assumptions made by academic writers such as David[359] and Bainbridge.[360] The real meaning behind the phrase 'judges are not business experts' or judges are 'ill-equipped …' should actually be referring to judges' inability to second-guess directors' business creativity irrespective of their business expertise. This argument is supported by the fact that business experts are available, either by way of business expert judges or business expert witnesses in the judicial system to deal with directors' business decision matters that have been governed by predefined rules (programmed business decisions); and not business judgment (Non-Programmed (Creative) Business Decisions).[361] In other words, the phrase 'ill-equipped to second-guess the business decision' simply means that the expertise in the judicial system is not capable to replace or to second-guess the business creativity of company directors. This is because the issue is not about the assessment of a programmed business decision which can be assessed by a predefined benchmark; but business creativity, which is not subject to any predefined rule. For this reason, my thesis will argue that the real factor goes beyond the question of business expertise.

First, let's look at the problem with expert witnesses. Expert witnesses are arguably more susceptible to the influence of bounded rationality both physically, cognitively and psychologically than the directors as a result of having less hand-on experience to the company's business and limited time and resources because expert witnesses are

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[359] (n 293)
[360] ibid
[361] See Chapter Two in general.

heavily subject to the institutional constraint of the judicial system.[362] This is a domino effect passed on by the judges who are operating within the rigidity of the judicial system.

The argument of bounded rationality against expert witnesses is further strengthened due to the fact that expert witnesses (being the agents of the state to act impartially within the scope of their duties but at the same time has to operate within the rigidity of the judicial constraint as mentioned above) can succumb to the risk of 'agency cost economics'.[363] This inter-connection between bounded rationality and agency cost means that judges cannot guarantee that the expert witnesses act in the best interest of the justice.[364] This is because under the theory of agency cost economics, the expert witnesses are likely to suffer from a potential conflict of interest between the time spent on the case and the time spent to run their own business, thus boundedly rational in their decision-making. In addition, they do not share the same risk as

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[362] Julian Velasco, 'Structural Bias and the Need for Substantive Review' (2004) Wash U L Rev Vol 82 821, 839; Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 118; See also generally, Chancery Guide, <www.chba.org.uk/for-members/library/.../chancery-guide-updated-october-2013, October 2013> accessed in 2013; See also, Kirton and Pender, 'The Adaption-Innovation Continuum. Occupational Type, and Course Selection' (1982) Psychol Rep Vol 51 883 as cited by Woodman et al, 'Toward A Theory of Organizational Creativity' (1993) Acad Manag Rev Vol 18 No 2, 293, 305

[363] Lucian Bebchuk and Jesse Fried, 'Pay Without Performance' (Harvard University Press 2004) (Preface and Introduction); see also Cheffins & Bank, 'Is Berle and Means Really a Myth?' (2009) The Business History Review Vol 83 No 3, 444

[364] See Husam F-Aldin Nizar Al-Walkawi and Rekha Pillai, 'Internal Mechanisms of Corporate Governance' (2012) Journal of modern Accounting and Auditing vol 18, 549, 548-658 - 'An **agency cost** is economic concept concerning the cost to a "principal" (an organization, person or group of persons), when the principal chooses or hires an "agent" to act on its behalf. Because the two parties have different interests and the agent has access to and control of more relevant information, the principal cannot directly ensure that its agent is always acting in its (the principals') best interests' - Lucian Bebchuk and Jesse Fried, 'Pay Without Performance' (Harvard University Press 2004) (Preface and Introduction); The term 'the agency cost economics' was also cited by Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 118

company directors whose failed decision can result in bad consequences, such as losing the offices as directors by way of the market that operates as a corporate control, which in turn serves a reasonable degree of deterrence to making bad business decisions. And the same success as company directors when a business decision was made with an aim to benefit the company. Company directors are therefore, intrinsically motivated to relentlessly pursue the success of a Non-Programmed (Creative) Business Decision in the best interest of the company as opposed to expert witnesses.[365]

The argument proposed by Hagle;[366] Bainbridge and Gulati[367]; and Langlaise[368] that judges are not fit to second-guess directors' Non-Programmed (Creative) Business Decision cases based on the assumption of bounded rationality, cannot, in my opinion, be overcome by the employment of expert witnesses. Nor can it be countered by the replacement of the non-business expert judges with a team of highly and commercially sophisticated people who possess a wide range of business knowledge, skills and experiences. This is because the degree of business expertise possessed by the expert witnesses or the judges bears no legitimacy. Business experts have no means to assess Non-Programmed (Creative) Business Decision/business judgment because this type of decision offers no benchmark for business experts to assess. As it

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[365] See Chapter Four that is massively dedicated to the topic on the inter-relationship between judicial or legislated deference and motivation from a psychology perspective.
[366] (n 336)
[367] ibid
[368] ibid

is purely based on business creativity of directors; and not bound by any predefined rule.[369] In other words, business creativity involves a large degree of element relating to commercial speculation and uncertainty. It is not a question of right and wrong relating to the quality of a business judgment within the realm of the business expert's professional understanding. Business creativity preventing judges from effectively examining the directors' business decisions have been well documented in cases such as *Overend Gurney & Co v. Gibb*;[370] *Howard Smith Ltd v. Ampol Petroleum Ltd*;[371] and *Iesini v. Westrip Holdings Ltd.*[372] Similar examples can also be seen in the US case - *Deal v. Johnson*.[373] In this case, the judge was able to get the answer on the straightforward business question from the company's in-house commodities experts because the in-house commodities experts were equipped to assess the merits of certain commodities contract based on the pre-existing in-house records (programmed business decisions) and the making of this programmed business decision was a matter of assistance from a certified accountant through a predefined accountancy rule. The court was however, not able to rely on any business experts' assistance to deal with the business judgment or Non-Programmed Business (Creative) Decision, i.e.,

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[369] See generally H.A. Simon, *The New Science of Management Decisions* (Joanna Cotler Books 1965)

[370] [1872] LR 5 (HL) 580 as cited by Moor, *Corporate Governance in the Shadow of the State* (Hart Publishing 2013) 155; and Tomasic, 'Corporate Rescue, Governance and Risk Taking in Northern Rock: Part 2' (2008) Comp Law 29(11), 333

[371] [1974] UKPC 3 (PC)

[372] [2009] EWHC 80 (Ch) (where the judges admitted that directors have better business connections with, for instance, suppliers and customers etc.; and that the court has to consider the financial impact of the claim on the company which severely limited the access to the company's financial resources); see also Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 98, 119 where the same limitation of resources applied to companies in the US.

[373] 362 So 2d 217 [Ala. 1978]

speculative business decision taken by the director on whether or not night baseball games would indeed contribute significantly to the overall profit making or interest of the company in *Shlensky v. Wrigley*.[374]

As explained above, because of the indifference of degree of suffering from the effect of bounded rationality by both expert and non-expert judges when facing directors' business judgment or Non-Programmed (Creative) Business Decisions, the real focus should be placed upon:

The inherent inability of the judge or expert witnesses to properly determine the quality of a business decision that is of unique and creative nature. The business decision-making power is exclusively privileged to the company directors as an appropriate independent organ of the company; and

That any judicial interference with such a business judgment would de-motivate directors from taking business risk, thus impairing directors' business creativity (*Wishart v Castlecroft Securities Ltd*[375]). In follows that when judges said that they were 'ill-equipped …' to determine on the right and wrong of the directors' business decision, they actually meant that no expertise was 'validly' available to judge the business creativity which was unique to each individual director who were motivated,

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[374] 237 ME 2d 776 [III. App. 1968]; see also Avishamlom Tor, 'The Fable of Entry: Bounded Rationality, Market Discipline and Legal Policy' (2002) 101 Mich L Rev 498

[375] [2009] CSIH 63 (ED) [37] as cited by Newey J in *Kleanthous v. Paphitis* [2011] EWHC 2287 (Ch) [71], [72] & [73]

thus relatively less boundedly rational, to strive for the success of the company (as pointed out by the judge in cases such as *Overend Gurney & Co v. Gibb*[376]).

To put it in a simplest way, the judiciary cannot properly assess the business judgment or Non-programmed (Creative) Business Decisions of company directors by relying on expert witness. Nor can it achieve this objective with a replacement of judges who are business experts. Therefore, the justification of whether or not judges are business experts is in reality referring to the business creativity of the director; and not the availability of business expertise in the judicial system. My thesis will argue that the real factor goes beyond the question of business expertise. The uniqueness and creativity of each business decision represents the core factor justifying judicial or legislated deference.

To give a better understanding of my research, I would like to first discuss and demonstrate the validity of my proposed core argument, i.e., the argument based on the inter-relation between the company law's deference and the concept of creativity by drawing a reference to an existing counter-argument proposed by academic writers, such as Arkes and Schipani; and Gevurtz. This counter-argument has been proposed against judicial deference underpinned by the Traditional Factor. The purpose of this referencing to these academic writers' counter-argument is to first place the focus on

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[376] [1872] LR 5 (HL) 580 as cited by Moor, *Corporate Governance in the Shadow of the State* (Hart Publishing 2013) 155; and Tomasic, 'Corporate Rescue, Governance and Risk Taking in Northern Rock: Part 2' (2008) Comp Law 29(11) 333

the difference between a medical decision and a business judgment/Non-Programmed (Creative) Business Decision. The difference is based on the unpredictability and creativity of a business judgment as opposed to the predefined programmed nature of medical decisions. Once the difference is established, I would then be in the position to use this difference to demonstrate that the justification in favour of judicial deference is not to be answered by the amount of business expertise available. This is because there is no predefined benchmark on which business expertise can accurately judge the quality of a non-programmed business decisions. It is a question of directors' business creativity.

In short, I will first examine the counter-argument against judicial deference on business decisions in comparison to medical decisions. And then demonstrate the faultiness of this counter-argument in support of the view that Non-Programmed (Creative) Business Decision is the justification of judicial deference in the context of directors' business decisions.

This counter-argument is based on the question that if an individual accepts that judges are not business experts, therefore, are not fit to judge directors for their business decisions, it is at the same time arguable that judges are not experts in other professional areas such as medicine-practice. In other words, business decisions are not more complicated and sophisticated when comparing with say medical issues. Therefore, there should not be double standard within the judicial system when dealing with business and non-business decisions. From this counter-argument, it is

not difficult to see the reason why certain academic writers would want to see that judicial deference being applied to other professions or have the principle being abolished altogether in all aspects of law.[377] The argument of consistency by comparing directors with other professions had also been mentioned or proposed by a number of other academic writers:

For instance, 'They do not explain, for example, why the same judge who presumably are able to resolve other commercial disputes are unable to decide whether a business decision was made negligently.'[378]; and

'Why the same judges who decide whether the same engineers have designed the compressors on jet engines properly … cannot decide whether a manager negligently failed to sack a subordinate who made an improvident loan.'[379]

Now let's look at the problem with Arkes and Schipani's; and Gevurtz's counter-argument. The problem is that, while understanding the fact that with professionals, for instance, medical doctors, who have to possess high level of the expert skills through obtaining the required medical qualifications and being regulated

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[377] Arks & Schipani, 'Medical Malpractice v. The Business Judgment Rule: Differences in Hindsight Bias' (1994) 73 Or L Rev 587, 613-617 (as cited by Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 83, 120); Gevurtz, 'The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?' (1994) CAL L REV 305 - 312 even went on to say that if judicial deference does not apply to other professional practices, then business judgment rule should altogether be abolished on directors' business decisions.

[378] Daniel R. Fischel, *'The Business Judgment Rule and the Trans Union Case'* (1985) Bus Law Vol 40 1437 – 1455; & 1439

[379] Easterbrook & Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 94 as cited in Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 83, 120

by their own predefined code of conduct and standard of care. All which would allow the court, when dealing with negligence and duty of care cases in medical malpractice, 'refer to the customary practice of the (medical) profession.'[380] Academic writers have argued that the counter-argument, however, ignores the fact that no qualification requirement as a legal prerequisite for someone to take an office as a company director. Consequently, it is arguable that judges when deciding if a director has failed to exercise certain skills and thus fallen below the expected standard of conduct, judges have no effective 'benchmark' to rely upon in reaching a proper judicial determination.[381]

The position regarding a non-business decision being capable of being assessed against a predefined benchmark was also mentioned by Melvin A. Eisenberg in his earlier article - 'The Duty of Care of Corporate Directors and Officers' in which he commented, 'Physicians often can defend the quality of their decisions by pointing to established protocol or accepted medical practice, and fact-finders use such protocol or practices as objective benchmarks to test the quality of their decisions.'[382]

The same view was echoed by Kenneth B. Davis. JR:

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[380] Hal. R. Arkes & Cindy A. Schipani, 'Medical Malpractice v. The Business Judgment Rule Differences in Hindsight Bias' (1994) 73 Or L Rev 597 as cited in Jeffrey O'Connell & Andrew S. Boutros, 'Treating Medical Mal-practice Claims Under the Variant of the Business Judgment Rule' (2002) 77 Notre Dame L Rev Vol 77:2 373, 382

[381] As argued by Greenhow, Annete, 'The Statutory Business Judgment Rule: Putting the Wind into Directors' Sails' (1999) Bond L Rev Vol 11, 42

[382] (1990) 51 U Pitt L Rev 945, 964

> We instead rely on expert testimony. Underlying that reliance is the assumption that there exists a generally accepted body of principles and procedures dictating how a reasonable neurosurgeon should respond in a variety of situations. Consequently, we are comfortable permitting the fact finder to draw interferences about what the defendant neurosurgeon should have done from the expert's opinion on what he or she would have done if confronted with the same situation.[383]

As we can see from the above, unlike directors' Non-Programmed (Creative) Business Decisions taken in a volatile business world; in the medical jurisdiction, benchmark is predefined. Indeed, similar non-deferential approach is also taken by the UK court in the context of medical negligence (as opposed to business judgments). For instance, the *Montgomery Principle (Montgomery v. Lanarkshire Health Board*[384]*)* which states that medical physicians' legal obligation of disclosure relating to types of treatments and any ancillary information to their patients represents a predefined protocol. This predefined protocol serves as an objective benchmark to assess the correctness of the medical decision. Failing to observe the *Montgomery Principle*, the medical physicians will be found medically negligent. The *Montgomery* represents the landmark case in medical law and has been consistently applied. For instance, in

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[383] 'Once More, The Business Judgment Rule' (2000) WIS L Rev 573, 582; see also Charles Hansen, 'The ALI Corporate Governance Project: of the Duty of Care and the Business Judgment Rule, a Commentary' (1986) 41 BUS Law 1237, 1240 where Hansen pointed out the uniqueness of each directors' business decision that cannot be validly assessed by any pre-defined benchmark.

[384] [2015] AC 1430 (SC).

the recent case known as *Webster (A Child) v. Burton Hospital NHS Foundation*,[385] whereby the programmed decision nature of the medical decision in the context of doctor's duty to advise their patients the material risk on treatments is upheld.[386]

To further the argument from another angle, Kenneth. B. David Jr has pointed out that as opposed to other professions (for instance, medical professions) which start with formal education as a pre-requisite for practicing the professions and followed by post-graduate vocational training courses and conferences, 'Corporate directors, as a 'profession,' lack any counterpart institutional arrangements to develop, debate, and disseminate professional standards.'[387]

In other words, if an individual wishes to legally proclaim to be in a certain profession with specific skills such as a lawyer or a physician, he would have to first obtain the relevant qualification and practicing license. Indeed, the same principles apply even to a regular car driver who has to first obtain a required driving license. However, there is no such license as 'the director's license' offering any benchmark to assess directors' Non-Programmed (Creative) Business Decisions. For the purpose of clarity, it is important to remember, as mentioned in Chapter Two, although directors are expected to possess the skills relevant to their business,[388] the types of business decision made by directors within the provision of the predefined rule governing the

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[385] [2017] EWCA civ 62 (CA)

[386] N. Tavare, 'Webster (A child) v. Burton Hospitals NHS Foundation (Case Comment)' (2017) JPI Law, C93-C96

[387] 'Once More, The Business Judgment Rule' (2000) WIS L Rev 573, 583

[388] *Norman v Theodore Goddard* [1991] BCLC 1027

running of the company's business is not the same types of business decision in the form of business judgment that cannot be assessed with any predefined rule.

Since there is no licensing requirement, there is no related vocational standard of conduct governing all types of business decisions of directors. Judges have no benchmark to rely upon when dealing with business judgment cases. Therefore, as mentioned in Chapter two, judges, when dealing with business judgment of directors, the judicial emphasis is placed, not on the right and wrong of the business decision, rather, on whether or not '… such a question, if bona fide arrived at'. – as per Lord Wilberforce *(Howard Smith Ltd v. Ampol Petroleum Ltd*).[389]

Now turning to the next question - can a counter-argument against the argument for lack of accepted protocol relating to directors, be proposed on the basis that there are training courses for company directors? For example, INSEAD Directors Training that helps to bring specific competences and credibility to the boards on which they serve? If so, courses like INSEAD Directors Training or the judicial expectation on which directors must exercise the corporate governance function or functional responsibility,[390] can arguably be taken by the courts to serve as an objective benchmark. And the benchmark can be used by the court in determining directors' negligence in the same way as other professions like medical practitioners. I will

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[389] [1974] UKPC 3 832 (PC)

[390] including the possession of the skill(s) that reasonably be expected to run the company's business (In the US, the case reflects these types of scenarios can be found in *Deal v. Johnson* 362 So 2d 214 [Ala.1978] which bears striking resemblance *to Norman v. Theodore Goddard* [1991] BCLC 1027 (Ch))

demonstrate in the following, that in a volatile mercantile world, these predefined benchmarks will only be useful for directors' programmed business decision; and not Non-Programmed (Creative) Business Decisions.

Before presenting my own analysis of the matter, I shall first refer to certain leading academic writers' opinions on judges' capability to assess the right and wrong of directors' business decisions. Once this is done, I will demonstrate my analysis to differ from their view.

Eisenberg has argued that the general training course is deemed to be an insufficient benchmark for the assessment of business judgment in the sense that unlike medical procedures, the unique nature and diverse backgrounds of each business decision makes directors able to 'seldom shield' the quality of their decisions by relying on any particular accepted protocol or practices. '… therefore, the fact-finders will seldom have an objective benchmark to guide them.'[391] Consequently, Eisenberg argues (and as I will discuss below that I do not agree on this point) that there is a fine line between non-business expert judges who rely on certain protocols as a benchmark in deciding a business decision case, and business expert judges who arguably serve a more effective role in the context of director's business decisions[392].

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[391] Melvin A. Eisenberg in 'The Duty of Care of Corporate Directors and Officers' (1990) 51 U Pitt L Rev 945, 964

[392] ibid

In other words, since there cannot be a licensing requirement on directors due to the diversification of the backgrounds and uniqueness of each business decision they make, there cannot be an effective relevant vocational code of conduct. Therefore, judges have no proper benchmark to rely upon to avoid uncertainty when dealing with directors' business decisions.

Eisenberg's view in favour of judges needs to be business experts to assess directors' business judgment is shared and more explicitly pointed out by Bainbridge who, however, had conveniently 'forgotten' Delaware Chancellors' or judges' highly qualified standard of review to insulate company directors from negligence liability by way of business judgment rule irrespective of the judges' business expertise (see for instance, *Aronson v. Lewis*[393]). Thus, renders his own following statement (in my opinion) self-conflicting:

Delaware chancellors sit at the 'center of the corporate law universe'. Unlike other courts, which face corporate cases only episodically, such cases make up a very high percentage of the Delaware chancellor's docket. The frequency with which they face such cases provide a strong incentive for Delaware's chancellors to master both doctrine and the business environment in which the doctrine works … Because so many major corporations are incorporated in Delaware, Chancery court cases are often high-profile and the court's decisions therefore, are subject to close scrutiny by

[393] 473 A 2d 805, 812 [Del. 1984]

the media, academics, and practitioners. The reputation of a Delaware chancellor thus depends on his or her ability to decide corporate law disputes quickly and carefully … For these reasons, the adage that 'judges are not business experts' cannot be complete explanation for business judgment rule.[394]

To summarize, my understanding of the above is that, Bainbridge is saying that Delaware judges are business experts; and other non-Delaware judges do not usually have the in-depth experience and knowledge in dealing with corporate matters. This is because the majority of companies have been registered at Delaware. Therefore, Delaware judges have better chance to be exposed to sophisticated company law cases. It follows that the issue of the availability of the amount of business expertise of judges cannot be used to completely to justify judicial deference. In other words, Bainbridge believes that the availability of business expertise of judges justifies judicial deference to the extent of non-Delaware courts. However, he is **struggling** to be convinced that the factor represents a complete justification simply because of the existence of the Delaware judges exercising business judgment rule, who are also business experts.

Here is where my argument differs from Eisenberg; and fills the 'gap' where Bainbridge struggled to find. In my opinion, Eisenberg, Bainbridge and the other academic writers mentioned above have not correctly identified the real justification.

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[394] Stephen M. Bainbridge, 'Business Rule as Abstention Doctrine' (2004) 57 Van L REV 83, 121

They have failed to realize that the real issue in determining the suitability of judges in directors' business decisions cases does not lie on the question of whether or not the judges are business experts. The real factor justifies judicial deference lies on the directors' creativity in their business decision.

This can be clearly demonstrated in the famous American case known as *Dodge v. Ford Motor Co*.[395] In this case; the plaintiffs who were the minority shareholders of Ford Motor Company brought a lawsuit against Henry Ford, President of the Company who was also the majority shareholder through possessing 58 per cent of the outstanding capital stock.

The minority shareholders claimed that Henry Ford's decision to withhold special dividends for shareholders in favour of the proposed project to massively expand the company's business by investing in new plants for car manufacturing was an act against the minority shareholder's interest.

In his defense, Ford claimed that his business decision was proposed having taken the country's employment opportunity into account as the proposed investment would result in the company having to employ more workers.

Ford nevertheless, admitted that he had told his fellow shareholders that their interest as members of the company was not a primary consideration in the business decision.

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[395] 204 Mich 459, 170 NW 668 [Mich. 1919] as cited by Robert Hamilton, *Corporations Including Partnerships and Limited Partnerships, Cases and Materials* (West Academic 1981) Chapter 6, 313

The court ruled that Ford's decision was unlawful in that a director is not entitled to solely benefit the public at the expense of the company's shareholders through non-distribution of profits. This is because the company was in profit-making business, not a charity.

Despite the ruling, in the process of reaching the judgment, the judges agreed that had the decision been made for profit seeking, they would not and were not capable to have interfered with the proposed expansion of the company's business, as the ultimate result of such a business decision including a possible increase of the products prices could not be predicted. The judges recognized that directors' need to be creative in the hope that a long-term business plan can be formed for business competition. The judges cited 'judges are not business experts' as a ground to justify their unwillingness to interfere with business judgment in general.[396] Here, we can see that even though the judge used the term 'judges are not business experts' which has an apparent misleading effect indicating the capacity of business expertise within the judicial system, the intention of the judges to use such a term was to recognize that they are not equipped to second-guess the business creativity of the director[397] which is unique and could not be accurately assessed by any predefined rule. Through this deferential approach, the judge implied that the unpredictability of a possible

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[396] Supreme Court of Michigan (1919) 204 Mich. 459, 170 NW 668 as cited by Robert Hamilton, *Corporations Including Partnerships and Limited Partnerships, Cases and Materials* (West Academic 1981) Chapter 6, 313

[397] Such a business decision had been made by the director as an independent organ of the company.

increase of the products' prices was not an issue to be capably handled by the use of any business expert witnesses.

In the British counterpart case known as *The Overend & Gursey v. Gibb* in which Lord Hatherley LC had adopted a similar approach by stating:

> I think it extremely likely that many a judge, or many a person versed by long experience in the affair of mankind, as conducted in a mercantile world, will know that there is a great deal more trust, a great deal more speculation, and a great deal more readiness to confide in the probabilities of things, with regard to success in mercantile transactions, than there is on the part of those whose habits of life are entirely of a different character. It would be extremely wrong to import into the consideration of the case of a person acting as a mercantile agent in the purchase of a business concern, those principle of extreme caution which might indicate the course of one who is not at all inclined to invest his property in any venture of such a hazardous character.[398]

A further emphasis of the above statement was put forward by the judge in *Dovey v. Cory*:

> I do not think it desirable for any tribunal to do that which parliament has abstained from doing – that is, to formulate a precise rule for guidance or

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[398] [1872] LR 5 (HL) 480, 495 as cited Marc Moore, *Corporate Governance in the Shadow of the State* (Hart Publishing 2013) 155

> embarrassment of business men in the conduct of business affairs. There never has been, and I think there never will be, much difficulty in dealing with any particular case on its own facts and circumstances; and, speaking for myself, I rather doubt the wisdom of attempting to do more.[399]

As we can see from the cases mentioned above, these cases have demonstrated the classic examples where judges have very clearly cited business judgment/Non-Programmed (Creative) Business Decisions (the opposite type of business decision to programmed business decisions[400]) as opposed to the availability of the amount of business expertise within the judicial system, as a justification for judicial deference.

This is evidenced by the fact that if the unpredictability involved in the creativity of the directors' business decision can be judged simply by way of business expertise, then business expert witnesses or business expert judges can always be at the disposal of the judicial system, to validly assess the quality of directors' business judgment without having the judicial diffidence as shown in the cases like *Dovey v. Cory*.[401] The fact is that Non-Programmed (Creative) Business Decisions is not governed by any predefined rule and therefore, different directors or business experts can

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[399] [1901] AC 477 (HL) 488 as cited Marc Moore, *Corporate Governance in the Shadow of the State* (Hart Publishing 2013) 155

[400] See Chapter Five for the types of business decisions. On this basis my thesis will explore, from a psychology perspective, on the types of decisions that are capable of being examined by judges based on a pre-defined benchmark. This will be greatly discussed in Chapter Five regarding the issues and inter-relations of company directors' programmed business decisions and judicial deference.

[401] [1901] AC 477 (HL) 488

potentially come out with different Non-Programmed (Creative) Business Decision to be taken in the interest of the company. The differences can largely be attributed to different degrees of commercial experience or business outlook of each individual decision maker; the prevailing business environment at the time the decision was made; and availability of resources & any other relevant factors. At this point, bounded rationality kicks in, with judges or business expert witnesses being more boundedly rational than the directors who have greater hand-on experience in the company's business; greater degree of motivation to succeed for the company;[402] greater resourses available to achieve a more commercially minded decisions; and the absence of the judicial constraint that applies to judges dealing with a trial.

In short, the issue of judges' business expertise as a ground for judicial deference does not, in reality, exist.

FINAL ANALYSIS

The conclusion in the above paragraph is further evidenced by my final analysis in this chapter through the following paragraphs. I will briefly use the psychology theory of motivation[403] to argue that directors as opposed to judges are motivated to be business creative and are therefore, less boundedly rational in comparison. This, I

[402] See Chapter Four discussing the effect of judicial or legislated deference on motivating directors' business creativity from a psychology perspective.
[403] See Chapter Four for a greater intensive research relating to the inter-connection between directors' psychology theories of motivation and directors' business creativity.

will first explain the similarity of judges, business experts and directors in terms of business expertise and from there, the difference between the parties through motivation will be shown.

First of all, primarily the aspect that relates to the 'imperfection' of both parties is similar to the imperfection of both judges and expert witnesses. In other words, similar to judges, company directors can also be subject to the risk of agency costs,[404] after all, most directors are not the owners of the company. Directors are merely acting as agents for the company, therefore, (as previously mentioned) Bainbridge's argument that judges suffering from agency cost economics as opposed to company directors without further and proper justification, are, in my opinion, *prima facie* inconsistent, i.e., this argument is only showing one side of the coin.

For the purpose of my discussion, I will call the above problems – the 'Inconsistency Theory'.

As already mentioned above, I will not solely place the reliance on the Inconsistency Theory as an argument against the theory that judicial or legislated deference based on the argument of 'judges are not business experts' referring to the judges' expertise. I will, however, develop the main premises of my discussion from the perspective of the Inconsistency Theory. The aim of this approach is to demonstrate that judicial or

[404] Although relatively less likely than judges and expert witness due to the punishment received under market that operates as corporate control.

legislated deference is justified with reference to directors' business creativity, and not on the availability of judges' business expertise.

To give a clear view of the picture, I would first examine the issue from an opposite perspective by asking the question – since the Inconsistency Theory demonstrates that, when it comes to **making of Non-Programmed (Creative) Business Decisions**, company directors are not much of 'business experts' to that of judges (This is because no predefined benchmark exists to both parties in accurately predicting the quality of the business judgment), then what makes or allows a non-business expert to act as a company director? And why is it that a non-business expert should not be expected to act as a judge? In other words, what are the differences between a director and a judge when both are under the circumstances of being 'non-business experts' to begin with?

In the process of answering the above proposed question, I will also, at the same time, address another inconsistency issue pointed out by Fischel, i.e., that the problem of relying on the justification of 'judges are not business expert' is that, it does not 'explain why causing corporate managers to be more cautious is not beneficial much in the same manner that the effect of tort suits causing automobile drivers to be more careful is beneficial'.[405] In other words, what Fischel means is that the problem with justifying judicial deference on the basis of the expertise of the judges in the field of

[405] Daniel R. Fischel, 'The Business Judgment Rule and the Trans Union Case' (1985) Bus Law Vol 40 1437 – 1455, 1439

dispute is that in general, judges tend not to be experts. Therefore, if the expertise of the judges is to be relied upon as a justification for judicial deference, then we are going to see a double standard on business decision cases with possible deference; and non-business decision cases such as traffic negligence, without any deferential protection.

Fischel's argument is based on the faulty presumption that all types of business decisions made by company directors are pre-programmed in nature with the availability of a predefined system to assess the quality of the decision. We need to look at the judicial deference from the perspective where justification which is based on directors' Non-Programmed (Creative) Business Decisions as opposed to the assessment of programmed decision in traffic disputes. And thus, judges are, not equipped to decide right and wrong in the quality of the Non-Programmed (Creative) Business Decisions (as illustrated in cases such as *Howard Smith Ltd v. Ampol Petroleum Ltd*[406] with reference to *Hogg v Cramphorn Ltd*;[407] and *Extrasure Travel Insurance Limited v. Scattergood and Others*[408]). Once the distinction is clearly drawn between auto-mobile drivers who are bound by the predefined traffic rules; and company directors in the context of making a Non-Programmed (Creative) Business Decisions, then judicial deference in the context of directors' business judgment will

[406] [1974] UKPC 3 (PC)
[407] [1967] CH. 257 (Ch)
[408] [2002] BCLC 1 (Ch)

not be irreconcilable, as opposed to the double standards that arise from justification on the basis of the availability of judge's business expertise.

In terms of business motivation, it is arguable (proposed by, for instance, Lord Hatherley LC; Lewison J; and Bainbridge) that the justifications for a non-expert director against a non-expert judge can be that a non-expert director tend to gain the business drive through commercial contacts and connections together with the financial resources that the company can offer to achieve the objective. These factors place a director in the role to carry on the business with the tendency of being business innovative and bubbling with creative and unique ideas (*Overend Guerney & Co v. Gibbs* [409]; and *Iesini v. Westrip Holdings Ltd*[410]). I will explain at the later part of this section that this tendency represents an essential element for the company's success in an intensely competitive market.

On the other hand,[411] however, non-business expert judges who do not operate in the same mercantile world, do not have the inspirations, connections and resources that the company directors do and therefore, judges are arguably not acceptable to replace

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[409] [1872] LR 5 (HL) 480 as cited by Kershaw, *Kershaw Company Law in Context: Text and Materials* (2nd OUP 2012) 423

[410] [2009] EWHC 2526, (Ch) [80] (where the judges admitted that directors have better business connections with, for instance, suppliers and customers etc.; and that the court has to consider the financial impact of the claim on the company which severely limited the access to the company's financial resources); see also Stephen M. Bainbridge in 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 98, 119 where the same limitation of resources applied to companies in the US.

[411] (This chapter is written with the view that the issue of directors being driven by greater motivation to success for the company than judges is being fully addressed by Chapter Four)

company directors in business decision making (*Overend Guerney* & Co *v. Gibbs*;[412] and *Iesini v. Westrip Holdings Ltd*[413]) as argued by Tor that this lacking of 'intense competitive pressures' allows 'even more far-reaching expression of bounded rationality'.[414] Consequently, judges are not equipped to second-guess the business creativity of company directors irrespective the amount of business knowledge possessed by the judges/judicial system.

To be further precise, my next question is, if the non-business expert judges do not have the essential factors such as business inspirations, connections and resources possessed by company directors, then would so called the business expert judges do? As analysed in the following paragraphs, the answer is no.

Business expert judges have higher awareness and understanding of commercial and corporate transactions as opposed to non-business expert judges. For instance, business expert judges will have better grasp of consumer credit, such as the concept of present value and they are most likely to be selected based on their business knowledge and sophistications as opposed to non-business expert judges who are selected on their good character and the presence of diversity on the range of persons available in the judicial system.[415] Business expert judges, however, do not possess

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[412] [1972] LR 5 (HL) 480 as cited by Kershaw, *Kershaw Company Law in Context: Text and Materials* (2nd OUP 2012) 423

[413] [2009] EWHC 2526 (Ch) [80]

[414] Avishamlom Tor, 'The Fable of Entry: Bounded Rationality, Market Discipline and Legal Policy' (2002) 101 Mic L Rev 568

[415] Section 63 of Constitutional Reforms Act 2005.

the same business inspirations or motivation which can be either intrinsic (driven by deep interest and involvement in the work, by curiosity or personal enjoyment and satisfaction) and/or extrinsic (driven by an external motivation such as associated financial rewards).[416] Business expert judges do not have the same level of business contacts as that of company directors. Thus, business expert judges are more boundedly rational than directors in the absence of these motivators which severely limit their capacity to understand and appreciate directors' business creativity.

[416] The interrelation between creativity/innovation and motivation has been heavily researched by many researchers such as Amabile. How company directors have the tendency to possess higher degree of motivation to business creativity will be discussed in Chapter Four.

CONCLUSION

The Traditional Factor – 'judges are not business expert' or 'judges are ill-equipped …' whilst appears to justify judicial or legislated deference from a perspective of the availability of business expertise within the judicial system, it does not fully stand up to close scrutiny. First, there is no shortage of business expertise in the judicial system for the purpose of assisting the judges to understand business transactions in general in the trial. Furthermore, Section 63 of Constitutional Reforms Act 2005 ensures (through the recruitment process) the availability of some business expert judges. Therefore, it is incorrect to assert that judges are not business experts. However, whilst business expertise can be treated as a standard to assess any business decision with a clear predefined rule; business expertise cannot serve as an effective benchmark to assess Non-Programmed (Creative) Business Decisions, i.e., business creativity which takes the form of uniqueness based on the circumstances. Secondly, (as opposed to directors) greater limitation of bounded rationality affect judges as well as expert witnesses irrespective of the degree of their business expertise. This severely limits their capacity to properly understand the complexity of Non-Programmed (Creative) Business Decisions.

Whilst it is arguable that, when it comes to business creativity, as opposed to functional responsibility or corporate governance functions of directors, company directors are not all business experts and can also be limited by bounded rationality,

however, directors are 'intrinsically' motivated to be business creative in the interest of the company.[417]

Therefore, judicial or legislated deference justified by the term 'judges are not business experts' is NOT referring to judges lacking business expertise but to the creative nature of directors' business judgments.

This chapter establishes the true meaning of the Traditional Factor justifying judicial or legislated deference based on company directors' business creativity. Chapters Four and Five will respectively use the relevant psychology theory to define business creativity and types of business decisions; Chapters Four and Five will also use a number of economics theories, to discuss the significance of business creativity to the success of a company. And demonstrate, from a psychology perspective, that the company law's deference promotes motivation that intrinsically enhances company directors' business creativity.

[417] See Chapter Five for the theory of intrinsic and extrinsic motivation.

CHAPTER FOUR - CREATIVITY, MOTIVATION AND JUDICIAL DEFERENCE

CHAPTER INTRODUCTION – BREIF REVIEW OF CHAPTERS TWO & THREE

Chapter Two discussed the existence of UK judicial deference in common law. Its similarities to the US business judgment rule with the protection being offered to company directors based on their business decisions that are of creative nature as opposed to the exercise of their pre-programmed functional responsibilities; and how the judicial deference found its way into the Companies Act 2006. Chapter Three examined and identified the factors that justify such a judicial or legislated deferential approach; and concluded that when the judges used the traditional term - 'judges are not business experts' or 'judges are not equipped to …' deal with company directors' business judgment, they actually referred to their inability to interfere with directors' business judgment or business creativity.[418] This is because this type of business decisions, made by the directors, is of unique and creative in nature; and exclusively exercisable by the company directors as independent organs of the companies.

[418] Or as duped by this thesis – Non-Programmed (Creative) Business Decisions (see Chapter Five).

OVERVIEW OF CHAPTER FOUR

As revealed by both Chapters Two and Three that company directors' business decision-making is a creativity process that involves, often, a great deal of uncertainty. Such element of speculations, with the decision-making process not bound by any predefined rules, goes beyond the business expert's capacity to assess. Business creativity, therefore, justifies, as well as provides a normative approach as to the application, from the judges' perspective, judicial or legislated deference. Business creativity represents the central focus of this thesis; and it is a subject that has been heavily researched in psychology. This Chapter will, therefore, seek to use psychology studies to formulate a definition of creativity. The formulated definition underpins the proposed concept of creativity for the purpose of judicial or legislated deference within the context of company directors' business decisions.

One question that needs to be addressed in this thesis is the importance of finding out what is it about business creativity that has been desired so much focus by many companies. Apart from what has been covered in Chapter Three relating to the business experts' judges' inability to assess creativity, what are the economic benefits of business creativity to companies? To find out the answers, this chapter will aim to use the economics theories to explore and demonstrate the significance of creativity and innovation in directors' business decision-making. The economics analysis links to the psychology theory of creativity in the sense that psychology provides a suitable definition of business creativity; and economics gives insights into the

economic or financial benefits of business creativity to companies. Examinations on the economic theories of creativity will be undertaken; and explanations will be given as to why definitions of creativity in economics are not as suitable for the purpose of this research as opposed to psychology. As this Chapter will show, the significance of business creativity is widely appreciated by many companies.

Over the years, the law has been playing an important role in motivating company directors to be business creative for the benefit of companies. This Chapter will critically analyse psychology theories of motivation which underpins creativity. This Chapter will demonstrate how the current UK law has been made in line with the theories in psychology to recognize the importance of business creativity within the context of legislated deference; and such a deferential approach serves as a 'motivator' that 'promotes' company directors' business creativity exercised in the interest of companies.

In short, this Chapter aims to formulate the definition of company directors' business creativity; discuss the economic benefits of business creativity to companies; and demonstrate how the current UK company law's deference psychologically motivates company directors' business creativity.

This Chapter is not aimed to operate independently. It is aimed to closely link to Chapter Five as 'phase one' that leads to the types of business decisions. Chapter Five will, therefore, formally introduce my proposed concept known as Non-programmed

(Creative) Business Decisions. Consequently, the final experiment (through case studies) on types of business decisions within the context of judicial or legislated deference will essentially be conducted towards the end of Chapter Five.

The reason that this research is not a pure law research lies on the fact that the significance of business creativity to companies; the definition of creativity; and the inter-relationship between judicial or legislated deference, creativity and motivation cannot be fully answered by **purely** relying on law or legal studies (in the total absence economics and psychology). This is due to insufficient research in this field.[419] This insufficiency leaves the 'gaps' preventing the advancement of this research.

I have overcome this limitation by going beyond the law; and using other fields of studies where sufficient researches have been specifically undertaken relating to business creativity and motivation. This will involve the economics where a large amount of studies undertaken to establish the significance of creativity in company directors' business decision-making; the field of psychology (including managerial psychology) where a substantial amount of research on creativity has been done; and again, the field of psychology (including managerial psychology) on the issue of

[419] For the purpose of clarification, the subject of law and creativity has been done numeral times. However, this field of studies has been mainly conducted from the perspective of intellectual properties law in the context of psychology. For instance, studies addressing the issue on whether or not patent & copyright law promotes creativity; see for instance, G N Mandel, 'To Promote the Creative Process: Intellectual Property Law and the Psychology of Creativity' (2011) Notre Dame L Rev Vol 86; or Bucafusco et al, 'Experimental Tests of Intellectual Property Law's Creativity Threshold' (2014) Tex L Rev 1921

motivation for the same reason. By exploring the other fields of studies, the 'gaps' identified in the field of legal studies can be fully answered.

CHAPTER FOUR BREAKDOWN

To succinctly cover the points mentioned above, each heading of this chapter is set out in logical order. Specifically, I shall break down the chapter into the following sections:

a. This chapter will first deal with the primary issue, i.e., formulation of the definition of creativity. The definition will be crafted specifically for the application of judicial or legislated deference in the context of directors' business decisions. The creativity definition needs to be formulated as it serves as a component used to identify business creativity for the purpose of this research. In other words, it forms an essential part of my final proposed concept of Non-Programmed (Creative) Business Decisions. Psychology studies in creativity definitions have been massively undertaken by experts. Accordingly, psychology will be the main source on which my research in this area will be conducted.
b. Once a common understanding of the definition of business creativity or the business innovation is established, this chapter will move on to deal with the second issue, i.e., the significance of business creativity. If business creativity is not important to the interest of companies, then there is no point to justify judicial or legislated deference in the context of directors' business decisions on the ground of creativity. Therefore, this chapter will seek to explore and establish the significance of business creativity to companies. This will be done by relying on economic arguments with the support of some law case studies.

c. Finally, this chapter will discuss the theories of motivation in psychology. This aims to demonstrate how company directors' business creativity can be motivated by the law. To compensate the limitation of the relevant research in the law relating to directors' business decisions, this section will demonstrate through the psychology theories that even though Articles of Association can be drafted to allow companies to engage in all types of business; and legislated deference (under Part 11 of Companies Act 2006) insulates directors from negligence liability in relation to their business judgment, the relevant legal regime has not been explicitly drafted to encompass creativity. Consequently, gaps have been created for this research to establish, from a psychology perspective, on UK company law's deference to provide an insight as to how the law motivates directors' business creativity.

d. In addition, I will use the psychology theory of motivation to demonstrate that directors are more business creative than judges even when both parties are non-business experts. This supports the conclusion in Chapter Three, i.e., that the justification for judicial deference lies on business creativity of company directors. And not on the Traditional Factor interrogating the business expertise of judges. This chapter enables me to look at how directors' business creativity is motivated by judicial or legislated deference leading up to Chapter five – Types of Business Decisions. This Chapter is done with an aim to complete the construction of the central component of this thesis which is known as Non-Programmed (Creative) Business Decision.

DEFINITION OF CREATIVITY

As mentioned in the above introduction, this chapter will first define creativity. Followed by the discussion of the significance of business creativity to companies. As the central objective of this thesis is to examine UK judicial or legislated deference (from a psychology perspective), on how the system promotes company directors' intrinsic motivation of wanting to make Non-Programmed (Creative) Business Decisions, a suitable definition of creativity needs to be in place to achieve the central objective.

As mentioned in Chapter Two, although the court has historically been able to differentiate the distinction between business decisions that take the form of business judgment; and director's functional responsibilities governed by predefined rules, with the former types being eligible for judicial deference. The legal identification alone, however, presents difficulties in examining the law under the field of psychology. This is because psychology has its own method of identifying creativity/innovation. And to achieve an effective interdisciplinary research, it would be necessary to first understand creativity in psychology by way of seeking an appropriate definition amongst a number of the relevant definitions. This is because creativity in psychology has been defined in different ways depending on the goals of the studies.

As economics was selected to examine the significance of creativity to companies, I shall also go through the relevant definitions in economics. I shall demonstrate that although each of the definitions was formulated pertaining to innovation, they are not as useful as the definition in psychology which has been closely linked to the studies of motivation for the purpose of this research.

The difficulties of selecting a suitable definition of creativity has been widely recognized by many academic writers, for instance, Reilly and Clemen have said, 'We readily recognize creative acts and often use the adjectives like novel, insightful, clever, unique, different, or imaginative. But coming up with coherent and useful definition of the term *creativity* is not easy.'[420]

And Prentky has philosophically commended on the formulation of a suitable definition being centered very much on the objective of the study that one is trying to achieve, 'What creativity is, and what is not, hangs at the mythical albatross around the necks of scientific research on creativity.'[421]

As indicated from the quotes above, there have been a great diversification and fragmentation of the terms 'creativity' or 'innovation' which have resulted in analytical and conceptual approach to creativity problematic. Dimock has said that:

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[420] Robert T. Clemen and Terence Reilly, *Making Hard Decisions with Decision-Tools (*1st edn, Brooks/Cole 2004) 219

[421] Prentky R. A., 'Mental Illness and Roots of Genius' (2001) Creat Res J 95 (as cited by Mark Batey and Adrian Furnham, 'Creativity, Intelligence and Personality: A critical review of a Scattering Literature.' (2008) Genet Soc Gen Psychol Monogr, 355)

> Directly or indirectly, and over a long period of time, a great deal has been written about creativity. But no one theory is presently completely accepted. One reason for this is that different fields of knowledge require different factors in combination[422]

and 'a second factor is that some commentators stress one factor, and others stress different ones in theory evaluations of relative importance.'[423]

Consequently, academic writers such as Dimock,[424] Gunday,[425] Amabile,[426] Reilly and Clement[427] have all pulled together a number of different thoughts from other academic schools with attempts to come to their own conclusions as to which definition is the most appropriate for the purpose of their studies.

Similar to many writers,[428] due to the closely identical features between the terminologies, both the terms 'creativity' and 'innovation' will at times be used interchangeably in most part of this chapter.

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[422] M. Dimock, 'Creativity' (1986) Public Administration Review, 46 (1), 3, 3 - 4; see also De Sousa et al, 'Creativity, Innovation and Collaboration Organizations' (2012) *IJOI* 1, 2

[423] ibid

[424] ibid

[425] Gunday et al, 'Effect of Innovation Types of Firm Performance', (2009) 4 < http://research.sabanciuniv.edu/13660/1/Gunday_et_al_Effects_of_Innovation_on_Firm_Performance.pdf> accessed 16th July 2016

[426] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisation' (1988) J Organ Behav, 125, 126

[427] Robert T. Clemen and Terence Reilly, *Making hard Decisions with Decision-Tools (1st,* Brooks/Cole 2004*)* 219

[428] L.D. McLean, 'Organizational Culture's Influence on Creativity and Innovation: A Review of the Literature and Implications for Human Resource Development' (2005) Adv Develop Hum Resour 226, 227

Once again, a reminder, this section is closely linked to the Types of Business Decisions in Chapter Five for the purpose of formulating a complete concept of Non-Programmed (Creative) Business Decisions as part of contributions to human knowledge. Therefore, the ultimate case studies to demonstrate how the designed definition of creativity can be applied in law will only be conducted at the end of Chapter Five. This section, therefore, serves as a preliminary stage for the proposed concept.

TYPES OF ECONOMICS DEFINITIONS OF INNOVATION/CREATIVITY

Broadly speaking, there are three types of innovations in the field of business and economics which have been reviewed in consolidation by Oslo Manual. Oslo Manual is 'a handbook on measuring innovation activities, It forms the conceptual basis of many recent innovation surveys, where amongst the most important is the Europe-wide Community Innovation Survey (CIS).'[429]

The three types of economic creativities are: 1. Product and process innovation (these include financial innovation); 2. Marketing Innovation; and 3. Organisational Innovations.[430]

The definitions of each type of economic innovations are generally discussed below to demonstrate their natures. Conclusion will be drawn to determine if any of the

[429] Torben Schubert, 'Marketing and Organizational Innovations in Entrepreneurial Innovation Process and their Relation to Market Structure and Firm Characteristics' (2010) Rev Ind Organ, 189, 212

[430] (n.8) See also generally Organisation for Economic Co-operation and Development, Oslo Manual, (1st edn, Eurostat, European Commission 2005)

types of economic innovations is suitable to be used to identify a Non-Programmed (Creative) Business Decision within the context of UK company law's deference. Each of the definition has been selected to ensure that all the areas relevant to each types of innovation are covered.

As mentioned above, the economic definitions of innovation have been chosen for this research to answer the question pertaining to why they (as opposed to psychology) are not suitable definitions for the purpose of this research. Thus, the center point of this research is the examining of the effect of UK company law's deference (from a psychology perspective, NOT from an economic perspective) in motivating business creativity.

PRODUCT AND PROCESS INNOVATION

It is commonly and traditionally recognised amongst writers such as Weiss, Gunday et al, and Lederman, that product and process innovation are interlinked as they are 'closely related to the concept of technological developments'[431], hence they are being classified under the same category.[432]

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[431] Gunday et al, 'Effect of Innovation Types of Firm Performance', (2009*)* 4 < http://research.sabanciuniv.edu/13660/1/Gunday_et_al_Effects_of_Innovation_on_Firm_Performance.pdf> accessed 16th July 2016

[432] Gunday et al, 'Effect of Innovation Types of Firm Performance', (2009) 4 < http://research.sabanciuniv.edu/13660/1/Gunday_et_al_Effects_of_Innovation_on_Firm_Performance.pdf> accessed 16th July 2016; See also Organisation for Economic Co-operation and Development, Oslo Manual, (1st edn, Eurostat, European Commission 2005) (also cited by Ginday et al in the above article); Pia Weiss 'Adoption of Product and Porcess Innovation in Different Markets: The Impact of Competition' (2003) Rev Ind Organ, 301, 314; Daniel Lederman, 'An International Multilevel Analysis of Product Innovation' (2010) JIBS 606, 608

Oslo Manual defines Product Innovation as ' … implementation or commercialisation of a product with improved performance characteristics such as to deliver objectivity new or improved services to the consumer.'[433] Similar to Oslo Manual, but putting stronger emphasis on the technology of the industry as opposed to consumer needs, other academic researchers such as Anderson and Tushman, have defined product innovation as 'technological discontinuities that advance by an order of magnitude the technological state-of-the-art which characterizes an industry.'[434]

A process innovation can be defined as '… the implementation or adoption of a new or significant improved production, delivery methods. It may involve changes in equipment, human resources, working methods or a combination of these.'[435] Or 'generally as changes in throughout technology for an organisation or operating units, such as plants, that are new to the industry.' – Bigoness and Perreault.[436]

MARKETING INNOVATIONS

As the name suggests, marketing innovation is predominantly marketing or product or service promotion orientated. It has been defined that 'A marketing

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[433] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn, Eurostat*, European Commission 2005)* 9

[434] P. Anderson and M. Tushman, 'Managing Cycles Through Technological Change' (1991) RTM 26-34 (as cited by Danupol Hoonsopoon and Guntalee Ruenrom 'The Impact of Organizational Capabilities on the Development of Radical and Incremental Product Innovation and Product Innovation Performance' (2012) JMI 250, 251)

[435] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn, Eurostat*, European Commission 2005)* 9

[436] WJ Bigoness 'A Conceptual Paradigm and Approach for the Study of Innovators' (1981) Acad Manag J 68 (as cited by John E. Ettlie and Ernesto M. Reza, 'Organizational Integration and Process Innovation' (1992) AMJ 795, 796)

innovation is the implementation of new marketing method involving significant changes in product design or packaging, product replacement, product promotion or pricing.'[437] Kotler said that:

> Marketing innovation is primarily targeting at 'addressing customers' needs better, opening up new markets or newly positioning a firm's product on the market with the intention of increasing the firm's sale. Marketing innovations are strongly relating to pricing strategies, product package designed properties, product placement and promotion activities …

And similarly, Levitt believes marketing innovations is defined as implementation by company that are 'specifically charged with dreaming up new marketing methods designed to fulfilled specific customers' needs that management or marketing researches have spotted or designed simply to increase the efficiency of distribution.'[438]

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[437] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn, Eurostat, European Commission 2005*)* 49 (as cited by T Schubert, 'Marketing and Organizational Innovations in Entrepreneurial Innovation Process and their Relation to Market Structure and Firm Characteristics' (2010) Rev Ind Organ 189, 190); and Gunday et al, 'Effect of Innovation Types of Firm Performance' *(2009)* 3,4 < http://research.sabanciuniv.edu/13660/1/Gunday_et_al_Effects_of_Innovation_on_Firm_Performance.pdf> accessed 16th July 2016; and P Kotsler , *Principles of Marketing (1st, Pearson, 1991)* as cited by Gunday et al, 'Effect of Innovation Types of Firm Performance', (2009) 1, 3 < http://research.sabanciuniv.edu/13660/1/Gunday_et_al_Effects_of_Innovation_on_Firm_Performance.pdf> accessed 16th July 2016

[438] 'Growth and Profits through Planned marketing Innovation' (1960) JM 1, 2

As the name suggests, organisational innovation is very much organisational or management orientated. For instance, Oslo Manual states that organisational innovation should involve, 'the introduction of significant changed organisational structures; the implementation of advanced management techniques; and the implementation of new or substantially changed corporate strategic orientations.'[439] In short, Organisational Innovation is defined as '…the implementation of a new organisational method in the firm's business practices, workplace organisation or external relations.'[440] This definition suggests that organizational innovation is of non-programmed nature as opposed to company directors' predefined functional responsibilities, e.g., a hypothetical directors' decision to discontinue a derivative claim based on a predefined legal cost and compensation obtainable in a derivative claim *Franbar Holdings Ltd V. Patel.*[441] An example of a successful organizational innovation within the corporate setting would be Ford Motors Ltd who introduced 'line assembly' arrangement on work distributions between each of the work stations

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[439] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st, Eurostat*, European Commission 2005)* 36-37

[440] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn, Eurostat, European Commission 2005) 51 (as cited by T Schubert, 'Marketing and Organizational Innovations in Entrepreneurial Innovation Process and Their Relation to Market Structure and Firm Characteristics' (2010) Rev Ind Organ 189, 190); and Gunday et al 'Effect of Innovations Types of Firm Performance' (2009) 3. < http://research.sabanciuniv.edu/13660/1/Gunday_et_al_Effects_of_Innovation_on_Firm_Performance.pdf> accessed 16th July 2016;
and *P Kotsler, Principles of Marketing (1st, Pearson, 1991)* (as cited by Gunday et al, 'Effect of Innovation Types of Firm Performance' *(2009)* 1, 3 < http://research.sabanciuniv.edu/13660/1/Gunday_et_al_Effects_of_Innovation_on_Firm_Performance.pdf> accessed 16th July 2016)

[441] [2009] Bus L R D14

set up with different groups of factory workers to facilitate the achievement of speedy mass-production of cars with less cost.[442]

THE ECONOMIC DEFINITIONS ARE NOT SUITABLE FOR THIS RESEARCH

Although it is undisputed that the above three types of innovations are economic activities which are closely interrelated. Each of the definitions is nevertheless, defined to cover a specific area of innovation. They are not definitions that are of generic nature for the purpose of this research. The independence of the definitions can be shown, for instance, when a company launches an innovative product but such a product is incapable to achieve the market popularity without having a creative marketing strategy in place to promote the product. To do so, the company needs first to be organisationally creative to negotiate a contract to govern the operation of the business relationship between the company and its marketing agent.[443]

As each of the definitions only exclusively emphasises a specific area of creativity, I do not find them being suitable definitions of creativity for the purpose of this research. To be more precise, it can be argued that to effectively apply the definitions, one has to first determine whether or not the directors' business decision falls under product/process, marketing or organizational activities.

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[442] H. Ford & S Crowther, 'My Life and Work' (1922) <https://archive.org/details/mylifeandwork01crowgoog> accessed 19th November 2017

[443] See in general, for instance, T Schubert, 'Marketing and Organizational Innovations in Entrepreneurial Innovation Process and their Relation to Market Structure and Firm Characteristics' (2010) Rev Ind Organ 189, 190

However, in the real business world, company directors are in general, engaged in a very wider range of business activities which are often flexible and unpredictable (as commented by the judges in *Overend Gurney & Co v. Gibb* [444]; and *Dodge v. Ford Motor Co*[445]) The over-specific definitions in economics would present difficulties to examine the current company law's deference within the context of directors' business decisions. This is because under the current law, the two legal components of deference have been designed to take a general view into business decisions from a broader perspective. Namely, 1. That the director has to act as an appropriate independent organ of the company, in the process of making a bona fide decision for the benefit of the company (Section 263(2)[446]); and 2. That the decision made by the director (or hypothetical director acting under section 172 within the operation of sections 263(2) & 263(3)(b)[447]) forms a business judgment or Non-Programmed (Creative) Business decisions as opposed to a functional responsibility/corporate governance function or programmed business decision.[448]

A particular definition of creativity in Psychology has been defined to be closer in line with the two fundamental conditions for establishing judicial or legislated deference. This is discussed in the next sections.

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[444] [1872] LR 5 HL 480, 495
[445] [1909] 170 N.W. 668, [684]
[446] The Companies Act 2006.
[447] The Companies Act 2006.
[448] See Chapter Five for the definition of programmed business decisions.

SUMMARY

Economics has classified business innovation into a number of specific types. However, this over-specification limits the scope of which the definitions can be freely and flexibly used to examine, from a non-legal perspective, the type of business judgment exercised by company directors. This is so, because business judgments are unique in each case and can involve different elements in the commercial world that can be ranging from one specific type to another.

One single definition of innovation or creativity that can be used to embody or to apply to all types of business innovation is, therefore, desirable.

TYPES OF DEFINITIONS OF CREATIVITY IN PSYCHOLOGY

Similar to the above discussions, in the following sections, I shall first introduce each type of the psychology definitions. And then discuss the issue as to whether or not each of the definition is in line with the law. I shall demonstrate that the Product-Oriented Measure of Creativity is the most desirable definition that can be said to be closely related to the two fundamental components[449] of company law's deference within the context of company directors' business decisions.

Broadly speaking, definitions of innovation in psychology can be divided into two schools of thoughts, namely, the Personality Oriented Measure of Creativity; and the

[449] Namely: 1. The director acting as an appropriate independent organ of the company, in the process of making a bona fide decision for the benefit of the company (Section 263(2)); and 2. That the decision made by the director (or hypothetical director acting under section 172 in the operation of sections 263(2) & 263(3)(b)) is a business judgment as opposed to functional responsibilities.

Product-Oriented Measure of Creativity. In other words, historically, psychology researchers have been trying to figure out if innovation is inborn or socially produced.[450]

PERSONALITY ORIENTED MEASURE OF CREATIVITY

This is a theory which is in support of inborn creativity. As pointed out by Dimock that this is:

> One of the oldest and most widely supported in intuitionism. 'Don't ask me how I do it, I just know.' This is what a born carpenter often says and he may have little or no formal education … he has mental picture of how things are put together and work, and hence he knows intuitively what to do and in what order to do them. Others try just as hard but never seem to succeed … intuitionism is a highly respectable approach to creativity. Some of the best scientists give this as the principal explanation of creativity …[451]

Findlay and Lumsden have described Personality Oriented Measure of Creativity by stating that, 'We will use the term creativity to refer to the constellation of personality and intellectual traits shown by individual who, when given a measure of free rein, spend significant amount of time engaged in the creative process.'[452]

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[450] Marshall Dimock, 'Creativity' (1986) PAR 3, 3; see also Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisations' (1988) Res Organ Behav 140, 167

[451] Marshall Dimock, 'Creativity' (1986) PAR 3, 3

[452] Findlay and Lumsden, *The Creative Mind: Journal of Social and Biological Structures* (Academic Press 1988) as cited by both Teresa M. Amabile, 'A Model of Creativity and Innovation in

Other than reference to an individual being born with unique creative ability, Roger believes that these unique personality and intellectual traits must also be shaped by the availability of resources, background or circumstances of which the individual is subjected to. In other words, to be creative, one must not just possess the right personality and intellectual traits, he or she must also be in the right place and right time. This is known as the Process Oriented Measure of Creativity – a sub-branch of the Personality Oriented Measure of Creativity.[453]

Due to the almost exclusive emphasis being put on personality and intellectual traits of an individual, certain researchers such as Kirkpatrick and Edwin;[454] and Zaccaro[455] have developed and extended Personality Oriented Measures of Creativity theory into finding and explaining leadership success. The Personality Oriented Measure of Creativity involved complex assessment and observation of each individual subjects, for instance, by using the method of personality inventory checking.[456]

PRODUCT-ORIENTED MEASURE OF CREATIVITY

As mentioned above, the Product-Oriented Measure of Creativity represents another major school of thoughts in psychology. This relates to the studies of human

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Organizations' (1988) Res Organ Behav 123, 167; Michal D. Mumford, *Handbook of Organisational Creativity* (1st edn, Academic Press 2011) 361

[453] See generally, Rogers, C., 'Towards a Theory of Creativity' (1954) ETC: A Rev Gen Sem 11, 249 (generally cited by Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisations' (1988) Res Organ Behav 123, 140)

[454] S.A Kirkpatrick and Edwin. A Locke 'Leadership: Do Traits Matter?' (1991) Acad Manag Pespect, 48

[455] Stephen J. Zaccaro , 'Trait-Based Perspective of Leadership' (2007) Am Psychol 6

[456] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organization' (1988) Res organ Behav, 126

creativity. It now in fact, represents the most popular theory amongst the theorists and researchers[457] due to the flexibility on which a wide scope of psychology studies can be conducted. This is because as opposed to the Personality Oriented Measure of Creativity, where the focus of assessment on creativity is being put on an inborn personality or intellectual traits of an individual; the Product-Oriented Measure of Creativity is 'assumed that creativity can be studied by using a normal population not just exceptional individual'[458] and 'that creativity can be viewed as the property of products rather than people.'[459] As suggested by Amabile and her critics that one of the advantages of the Product-Oriented Measure of Creativity is that the creativity can be easily, consistently, reliably and objectively assessed by experts or non-experts in the field of the particular idea or product in terms of its creativeness. Such measures are considerably and relatively more straightforward than relying '…on either person or process measures in identifying creativity' due to the complexities involved in the observation and assessment on each individual test-subject with requirements of different personality and intellectual traits on different areas of creativity.[460]

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[457] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisation' (1988) Res organ Behav 125, 126; and Clement et al, *Robert T. Clemen and Terence Reilly, Making hard Decisions with DecisionTools (*1st edn, Cengage Learning, 2004) 218

[458] Teresa M. Amabile 'The Social Psychology of Creativity' (1983) J Pers Soc Psychol 357; and Joseph R. LaChapelle, 'Review on the Social Psychology of Creativity' (1985) NAEA 47, 47

[459] The word, 'product' does not mean that it is restricted to a product in its literal sense. It simply refers to any creative act. See this chapter below for greater discussion in the psychology meaning of the word, 'product'.

[460] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisation' (1988) Res Organ Behav, 126, 167

The contemporary proponents of the Product-Oriented Measure of Creativity include Woodman et al; Amabile; Oldham & Cummings; and Slater. The proposed definitions between the writers can contain slight variations, for instance, the use of the words, 'novelty', 'new' or 'Originality'. But largely the universally accepted conditions to establish a Product-Oriented Measure of Creativity lie on two key factors, namely: **product's novelty and usefulness.**[461] I shall discuss each of the factors in greater details below.

However, to go into the meaning of the above two conditions, one has to first understand the meaning of the word - 'product' within the definition. There is a limitation in the interpretation of the word, 'product' within the existing literatures, in the sense that most of the writers do not specifically interpret the term 'product', rather, it is indirectly referred to as creative in general sense.[462]

This means any creative act can be considered as a product within the meaning of Product-Oriented Measure of Creativity. Amabile has been relatively more blatant and specific than some of the other writers on the term 'product':

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[461] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organization' (1988) Res organ Behav Vol 10, 125, 126; Teresa M. Amabile, 'Innovation - How to Kill Creativity' (1988) HBR 77, 78; and Woodman et al, 'Towards the Theory of Organizational Creativity' (1993) ABR 293; and Douglas Slater, 'Creativity in Organization – the Goose which Can Lay Golden Eggs' (2001) RSA Journal 32

[462] See for instance, Marshall Dimock, *Creativity* (1st edn, Wiley on behalf of The American Society for Public Administration, 1986); Douglas Slater, 'Creativity in Organization – the Goose which Can Lay Golden Eggs' (2001) RSA Journal, 32, (2001); and Giles Hirst et al, 'A Cross-Level Perspective on Employee Creativity: Goal Oriented, Team Learning Behaviour, and Individual Creativity' (2009) AOM 290

> If we take individual ideas or product that can be reliably identified as creative by experts, then we can look at the person's qualities, the environmental factors … corresponding to the production to those ideas or products. Thus, the definition used here is based on products (ideas): creativity is the production of novelty and useful ideas by an individual or small group of individuals working together.[463]

Here, the term, 'product' clearly goes beyond the literal meaning of product. It includes the product in its literal sense, as well as ideas, such as creative form of services or as this research is centrally focusing on – company directors' Non-Programmed (Creative) Business Decisions.

In the following, I will discuss each of the two components which forms a Product-Oriented Measure of Creativity, namely, 1. Novelty; and 2. Usefulness. In doing so, I will discuss different views of the two components from different psychology researchers; and demonstrate that certain researchers' view of the two components are useful for my research due to the conceptual flexibility.

Novelty: The term 'Novelty' or 'originality' has been the subject of constant debate amongst the academic researchers. For instance, Newell, Shaw and Simon have suggested that the condition of 'novelty' refers to the literal meaning of 'new', in the

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[463] Teresa M. Amabile, ' A Model of Creativity and Innovation in Organization' (1998) Res organ Behav 125, 126

sense that the product of thinking 'should be unconventional … it requires the modification or rejection of previous acceptance of ideas'[464] Jackson and Messick agreed with Newell, Shaw and Simon on the novelty but went further to say that novelty must contain an element of 'Transformation of Constraint'[465], in that, the product must 'involve the transformation of materials in overcoming the conventional restrains'.[466] Similarly, Dacey and Madaus cited Bruner's explanation that the element of transformation refers to an 'effective surprise', i.e., that the product produces 'a shock of recognition following which there is no longer astonishment.'[467]

Dimock took the term 'novelty' into a completely new level by ambitiously claiming that the originality of the 'product' must be 'new possibly revolutionary in its wide circle of effects. Like atomic fission or understanding the circulation of blood in the human system.'[468]

To place the Product-Oriented Measure of Creativity into the context of company directors' business decisions, the strict compliance with the condition with the

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[464] Newell, Shaw and Simon, 'The Process of Creative Thinking' (1958) presented at a Symposium on Creative Thinking, University of Colorado, 1, 4

[465] 'The Person, the Product and the Response: Conceptual Problems in the Assessment of Creativity' *(1965)* J Pers, Vol 33, 309 as cited by A. Reza Arastec and J.D. Arastec, *Creativity in the Life Circle* (E. J. Brill 1968), 72

[466] 'The Person, the Product and the Response: Conceptual Problems in the Assessment of Creativity' (1965) J Pers Vol 33, 309 as cited by A. Reza Arastec and J.D. Arastec, *Creativity in the Life Circle* (E. J. Brill 1968) 72

[467] Bruner, J.S. *On knowing,* (Cambridge, Mass: Harvard University Pres, 1962) (as cited by John S. Decey and George F. Facilitation, 'Creativity: Definition, Explanation and Facilitation' (1969) IJE Vol 3, No 1, 55, 56)

[468] M. Dimock, 'Creativity' (1986) PAR Vol 46, No 1, 3, 3

interpretation that the product must be new cannot be accepted for the purpose of this research.

Despite the fact that it is at the same time being acknowledged that the task must be open-ended, such interpretation fails to see the 'gap' and the conflict between the requirement of 'strict new response' and the condition of open-ended task. For instance, a company director who is facing a problem that is open-ended in solution This means that there is no predefined single solution governing the approach to resolve the problem. The director is then having the options to apply a number of solutions which might have already been used or applied by a third party in the past - a common situation occurred within the context of directors' business decisions (see for example, the negotiation of an overage agreement in the case of *Hildron Finance Limited v. Sunley Holdings limited*[469] as one of the cases in the case studies at the latter part of this chapter).

As mentioned at the beginning of the subsection that the term -'novelty' has been the subject of different interpretations between researchers and writers. And that the 'gap' identified in this paragraph can be overcome by another interpretation of the term 'novelty'. For instance, renowned psychologist H.A Simon has concretely defined the term 'novelty' through his proposed concept of Non-Programmed Decision which offers a higher degree of flexibility in the sense that whilst the condition of 'strict new

[469] [2010] EWHC 1681

response' can be an element within the novelty contained in a non-programmed decision, it is however, not essential; as novelty or matters that are of non-programmed are defined by the absence of a predefined or ill-defined rule that governs the way in which the decision (or product) is made.[470]

Similarly, other researchers such as Karry; and Maitland have argued that the strict compliance of 'new response' to the problem cannot be realistic in the real world and much would depend on the nature of the objective that the decision maker is trying to achieve. Karry has said, 'Creativity depends on previous knowledge, and therefore, depends to some extent on reproduction.'[471] Likewise, Maitland has pointed out:

> The Zen Calligrapher and landscape painter, however, paint in the manner of the masters of their tradition. Yet these works are inspired and original paintings, and what we look for when appreciating them is not an original solution to an aesthetic problem, but a creative performance. The implication is that we cannot comprehend creative activities unless we also know the nature of the object towards which the activity aims.[472]

Indeed, as Maitland has brilliantly summed up that 'creativity is a form of human freedom'[473] therefore, novelty is not about literal newness but a decision that is free

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[470] See generally H.A. Simon, *The New Science of Management Decisions* (1st edn, Prentice-Hall, 1965)
[471] Kerry Freeman, 'Rethinking Creativity': A Definition to Support Contemporary Practice' (2010) Art Education Vol 63 No 2, 13
[472] J. Maitland, 'Creativity' (1976) J Aesthet Art Crit Vol 34 No 4. 397, 408
[473] J. Maitland, 'Creativity' (1976) J Aesthet Art Crit Vol 34 No 4 397, 408

from the restrictive governing of any predefined regulations. This view was subsequently backed by the empirical studies of Amabile and Giltomer which yielded the result that 'imposing restrictions on how subjects may choose to complete a task has also proven detrimental to creativity.'[474]

This interpretation of novelty is very much in line with the legal understanding of business judgment within the operation of judicial deference or legislated deference under section 263(3)(b). As discussed in Chapter Two, business judgment is inherently non-programmed which is not subject to any predefined rule[475], for instance, where the judge in *Overend Guerney & Co v. Gibb* took into account of the ill-defined business environment when describing the type of business decisions as a '…conduct ... a great deal of more speculation … and a great deal more readiness to confide in the probabilities of things…'[476]; or *Iesini v. Westrip Holdings Ltd*[477]*; and Kleanthous v. Paphitis*[478] where the judge in considering section 263(3)(b), expressed a general deferential principle on the list of non-exhaustive commercial factors (exclusively emphasizing directors' business decisions that are not subject to any predefined policy) as opposed to company director's functional responsibilities which

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; see also Kristina Jaskyte and Audrone Kisieline, 'Determinants of Employee Creativity: A Survey of Lithuanian Non-Profit Organisations' (2006) VOLUNTAS Vol 17 No 2 133, 139

[474] T. Amabile and J. Giltomer, 'Children's Artistic Creativity: Effects of Choice in Task Materials' (1984) Unpublished Manuscript, Bradies University (as cited by Beth A. Hennessey, 'Social, Environmental, and Developmental Issues and Creativity' (1995) Edu Psychol Rev Vol 7 No. 2 163, 168)

[475] It should be stressed that the scope of predefined rules in the context of Novelty is not limited to legal rules, it includes non-legal rules such as conventions; and policies, for instance, companies' constitutions of which company directors are bound to follow in their decision-making process.

[476] LR 5 HL 480, 495

[477] [2009] BCC 420, (Ch) [85]

[478] [2011) EWHC (Ch) [71], [72]

is of programmed nature. For instance, director's duty of internal control management and corporate oversight as shown in the case of *re Baring plc and others (No. 5), Secretary of State for Trade and Industry v. Baker.*[479] The inter-connection between UK company law and the condition of Novelty is explored in greater details in the latter part of the chapter under the sub-heading: Product Oriented Approach & UK Company Law's Deference.

Usefulness: The term 'usefulness' within the definition of a Product-Oriented Measure of Creativity Theory does not refer to any specific result and for the purpose of this Chapter, the term 'usefulness' does not mean that the business decision of a director has to result the company in making any financial gain or avoiding an undesirable consequence, in order for a business decision to be 'useful' within the definition of creativity. This is so, as academic writers such as Kanter explicitly pointed out that the condition of usefulness in creativity can be successfully implemented through '…the process of bringing new, problem solving idea into use … Innovation is the generation, acceptance, and implementation of new ideas, processes, products or services.' [480]

Departing from Kanter's definition, the condition - 'new' has been removed by Parkhurst, which presents a definition to be closely in line with psychologist S. H.

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[479] [1999] 1 BCLC 433

[480] R.M Kanter, *The Change Masters* (1st edn, New Yorik, Simon and Schuster, 1984) (as cited by Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisation' (1988) Res organ Behav Vol 10, 126)

Simon's concept of non-programmed nature of creativity, i.e., the decision-making process is not bound by any predefined rule. It follows that the condition 'usefulness' is defined in a more problem-solving oriented fashion as 'the ability or quality displayed when solving hitherto unsolved problems, when developing novel solutions to problems others have solved differently, or when developing original and novel (**at least to the originator**) products'.[481] Or within the company directors' business decision-making context - developing a business judgment[482] to achieve the legal requirement imposed by section 172 companies Act 2006, i.e., act in the way he considers in good faith, would be most likely to promote the success of the company.

In line with Parkhurst, Barron and Harrington have further elaborated the term - usefulness as '… achievement in which there are novel products to which one can point as evidence, such as inventions, theories, buildings, published writings, paintings and sculptures and films; laws; institutions; medical and surgical treatments and so on …'[483]

Therefore, for instance, a business decision to make a non-waterproof smartphone into a waterproof smartphone would satisfy the requirements of 'usefulness'. This is because the waterproof function is an idea of problem-solving proposed to be put into

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[481] Parkhurst H.P. 'Confusion, Lack of Consensus, and the Definition of Creativity as a Construct' (1999) J Creat Behav 33 1, 21 (as cited by Mark Batey and Adrian Furnham, 'Creativity, Intelligence and Personality: A Critical Review of a Scattering Literature' (2008) Genetic, Social and General Psychology Monographs 123(4), 355)

[482] Or as coined by this thesis – a Non-Programmed (Creative) Business Decision.

[483] Frank Barron and David M. Harrington, 'Creativity, Intelligence and Personality' (1981) Annu Rev Psychol 32, 431, 439 -476

use. At which point, the implementation of the business idea or decision by the company is the final key element to establish the 'usefulness' condition within the provisions of the Product-Oriented Measures of Creativity.[484] The question as to whether or not the waterproof smartphone is a product of profit-making for the company is irrelevant within the context of the 'usefulness' condition.

The term 'usefulness' therefore extents to the 'product' (business decisions in the context of this research) which is being made **with an aim** to achieve usefulness but failed to reach a positive conclusion financially or non-financially to the company. In other words, in the context of company directors' business decision-making, the condition 'usefulness' would operate if the decision was made, bona fide, and in the interest of the company.[485] This is because company directors's fiduciary duties in the business decision-making process is confined by law only to make the decision, not for the benefit of third party, but for the benefit of the company. In other words, directors' business decisions have to be decisions 'that would be most likely to promote the success of the company' – section 172 Companies Act 2006. It should be noted that Keay and Loughrey have adopted a similar approach to the above which, I would argue, 'indirectly' pointing out the essential element of 'usefulness' in the

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[484] R.M Kanter, *The Change Masters* (1st edn, New York, Simon and Schuster, 1984) (as cited by Teresa M. Amabile, 'A Model of Creativity and Innovation in Organization' (1988) Res organ Behav Vol 10, 126)

[485] Douglas Slater, 'Creativity in Organization – the Goose which Can Lay Golden Eggs' (2001) RSA Journal Vol 148, No 5497, 32; Andrall E. Pearson, 'Tough-Minded Ways to get Innovative' (May/June 1988) HBR 66 No 3, 99

context of directors' fiduciary duties.[486] This is done via Knight's concept of entrepreneurial judgment, i.e., Knight had argued that when making a business judgment, directors would have to act 'as if they are entrepreneurs'[487]. This, as argued by Keay and Loughrey, must include the judgment being 'designed to advance, the interests of'[488] the company. The writers summed up this as follows:

> These decisions may display entrepreneurial ability in terms of risk taking and risk assessment or even in terms of creativity and innovation, but … do not advance the interests of the corporate enterprise and so should not be protected by business judgments. In sum, it is possible to conceptualize business judgment in the ability sense as entrepreneurial judgment: it is consistent with the scope and application of directors' fiduciary duties, and with the focus on risk-taking in discussion of directors' judgment.[489]

The concept of 'usefulness' above coincides with the subjective element in the legal process of determining whether or not deferential approach should be taken in the directors' favour by the court under section 263(2)(a). In which the court is to decide on whether or not the decision was made by the director, who was acting bona fide, as an appropriate independent organ of the company and in the interest of the company

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[486] Keay A & Loughrey J, 'The Concept of Business Judgment' Legal Studies 1, 14 < https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019

[487] ibid

[488] ibid

[489] ibid 17

(the conditions as seen in the cases such as re *Smith Fawcett Ltd*[490]; *Extrasure Travel Insurance Ltd v. Scattergood & Others*[491]; and *Stimpson v Southern Landlords Association*.[492]). The inter-connection between UK company law and the condition Usefulness is explored in greater details in the latter part of the chapter under the sub-heading: Product Oriented Approach & UK Company Law's Deference. It should be stressed that from a legal perspective, company director in the process of making a business decision must exercise his relevant power as an appropriate independent organ of the company of which, from a psychology perspective, the decision must be non-programmed in nature. In other words, there must not be any rule preventing the director from acting in the circumstance, as an appropriate independent organ of the company. This brings in the need to look into the complimentary concept of types of decisions proposed by H. A. Simon, of which, will be covered in Chapter Five.

The broad extent of the condition Usefulness was pointed out by Slater, 'For creativity also involves making a mess, and wasting time, and playing apparently aimless games of 'what if?' and 'just supposed we …?'[493] This concept can further be evidenced by Pearson[494] who has logically pointed out, that in practice, business

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[490] [1942] 1 (Ch) 304, 306

[491] [2002] BCLC 1 (Ch) [90], [97]

[492] BCC 387 (Ch) (also as cited in the case comment, 'Stimpson v Southern Landlords Association: Permission to Continue Derivative Claim Refused' (2010) Co. L.N. 277, 283-284); see also Tang, 'Shareholders' Remedies: Demise of the Derivative Claim?' (2012) UCL 182

[493] Douglas Slater, 'Creativity in Organization – the Goose which Can Lay Golden Eggs' (2001) RSA Journal Vol 148, No 5497, 32

[494] Andrall E. Pearson, 'Tough-Minded Ways to get Innovative' (May/June 1988) HBR 66 No 3, 99

innovation strategies tend to require gradual and incremental development and that directors are aware that business innovation strategies rarely work the first time as they were introduced. Director would have to put the original concepts of business innovation strategies into 'experiments' or 'trial & error steps' and gradually shape the strategies into their final forms.

The uniqueness on each trial & error step taken often cannot be fairly and properly assessed by any existing standard of care for ordinary negligence due to the inevitable risks involved. From the legal perspective, this psychology concept of 'experiments' or 'trial and error' manifested within the non-programmed freedom in creativity coincides with Newwey J's understanding in *Paphitis case* by following Lord Reed in *Wishart v Castlecroft Securities Ltd* to discontinue the actions against the directors for the making of their Non-Programmed (Creative) Business Decisions. The courts' rulings were passed through the recognition of the danger that even though the companies had great chances of success in winning the cases, resulted in a substantial damage being awarded against the directors; the consequences of the companies' success in the case might be at the expense of disrupting the board dynamics and de-motivate the directors from being business creative. This would in turn, damage the company's economy in the long run.[495] This deferential approach bears a striking resemblance to the US business judgment rule whereby judges are diffident in interfering with directors' business judgment in the fear of directors becoming

[495] See the above section dealing with significance of creativity to companies.

risk-adverse with the consequential damage to the company's trade performance in the future.[496]

SUMMARY

Personality Oriented Measure of Creativity exclusively focuses on the personal and intellectual traits of an individual (re personal and intellectual traits of a company director in this research). Therefore, it is not suitable to be used as a definition of creativity for the purpose of deciding whether or not a decision is creative within the context of this research. This is because the main question to be answered by this research centers on the business decisions of company directors within the context of legislated deference under the Companies Act 2006, rather than company directors as a people. In comparison to Personality Oriented Measures of Creativity, Product Oriented Approach is more appropriate for the purpose of this research. Through Product Oriented approach, one can measure up, to a reasonable level, the uniqueness, innovation and creativity of directors' business decisions that are beyond the judges' capability to second-guess, and in turn, serves as a justification for UK company law's deference. Another main point that this research aims to focus on, is the significance of directors' business creativity to their companies. In other words, this research is to focus on the aspect of showing that the law promotes and motivates

[496] Alfred. F. Conard, 'A Behavioral Analysis of Directors' Liability for Negligence' (1972) Duke L.J. 904; and M. A. Eisenbeg, 'The Duty of Care of Corporate Directors' (1989-1990) 51 U Pitt L Rev 958-959

directors' business creativity from a psychology perspective. This research is not conducting a journey in search of a creative genius.

The interpretation of novelty as a condition for establishing creativity varies between different academic researchers. Company directors' day to day business decisions seldom represent a strictly new response to problem-solving. Rather, there can be situations where directors are facing with a number of existing options to solve problems or achieve corporate objectives. Therefore, strict compliance with the common interpretation of novelty with reference to the literal meaning of the word, 'new' cannot be accepted as a condition for creativity for the purpose of this research. Instead, a fusion of PProduct-Oriented Measure of Creativity and H.A Simon's concept of non-programmed decision-making, i.e., a decision-making process which is not being governed by any predefined regulation will be adopted to construct a definition of creativity specifically apply to company directors' business decisions within the context of judicial or legislated deference.

The second criteria to establish creativity within the definition of Product-Oriented Measure of Creativity concept within the context of directors' business decisions (including 'trial & error' process) lies on the condition of 'usefulness'. This simply means that, in order for a business decision to be creative, the condition of novelty alone is not sufficient; the decision has to be made, bona fide, by a director and in the interest of the company.

As mentioned at the beginning of this section, a full demonstration of the application of the definition will be conducted in case studies towards the end of Chapter Five.

PRODUCT ORIENTED APPROACH AND UK COMPANY LAW'S DEFERENCE

This section is written with an aim to trace the elements of Product Oriented Approach of Creativity within the UK company law's deference under the Companies Act 2006.

As mentioned above, Product Oriented Approach of Creativity consists of two main components, namely, 1. Novelty; and 2. Usefulness.

Novelty is defined as a decision that is free from the governing of any predefined regulations; and **usefulness** in the context of company directors' business decision can be defined as a decision that is made in good faith and in the interest of the company.

As mentioned in Chapter Two, legislated deference within the current Part 11 of the Companies Act 2006 in the context of company directors' negligence is pre-dominantly found in the enforcement stage of negligence lawsuit. With regards to the types of business decisions, the company law's interference has been presumed inapplicable in the matters relating to directors' duties in supervision or internal

control.[497] However, judicial or legislated deference remains constantly applicable in the matters relating to directors' business judgments, for instance, under the enforcement stage of derivative lawsuit in Companies Act 2006, initiated by company shareholders.

Judicial deference over company directors' business decisions in the context of derivative claim has been in existence within the British common law for over a century (cases laid down this legal principle include *Howard Smith Ltd v. Ampol Petroleum Ltd*[498]*;* Smith *v. Croft (No. 2)*[499] *and Extrasure Travel Insurances Limited v. Scattergood and Others.*[500]*)*. There was almost no limitation as to the extent of the judicial deference, as derivative actions brought by shareholders of the company against company directors were mostly not actionable, with the exception of the situation where the director in question retained majority control of the company and that the directors obtained personal interest, as a result of their 'majority control', from the transaction.[501] The courts' diffidence to interfere with the company's management was based on the bona fide business judgment exercised by the appropriate independent organ and in the interest of the company.

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[497] For instance, *re Baring Plc and Others (No. 5)* [1999] 1 BCLC 433 (CA)
[498] [1974] UKPC 3 (PC)
[499] Ch 114 (as cited by Mayson and French and Ryan, Company Law (23rd edn, OUP Oxford 2006-2007) 664
[500] [2002] 1 BCLC 598, (Ch) [90] [97]
[501] For instance, *Pavlides v. Jensen* [1956] (CH) 565 (Ch)

The rule of wrongdoer's control was abolished by Part 11 of the Companies Act 2006. Derivative claim is now also available to company members acting in good faith, without having to satisfy the fraud on minority on the part of the board. However, this does not lead to the extinction of judicial deference. The current extent of judicial deference, signifies a departure from the traditional wrongdoer's control rule/fraud on minority, and substitutes it with legislated deference embodied by a more sophisticated rule. As shareholders who initiate the claim have to satisfy the hypothetical director test within the provision of Sections 263(2)(a) and 263(3)(b). Both under which the shareholders would have to convince the court that based on Section 172, the hypothetical director would continue the derivative claim in the interest of the company. This list of factors that judges would consider to be in the interest of the company is non-exhaustive. It follows that Part 11 of the 2006 Act reveals that legislated deference on matters of bona fide (broadly on subjective standard basis) business judgment exercised by appropriate independent organ in the interest of the company still operates within the Act.

To apply the two components of Product Oriented Approach of Creativity to the above, one can see a number of related traits. **First**, that the deferential approach being only applied to business judgment (as opposed to directors' functional responsibilities/corporate governance functions, for instance, the directors' responsibility to follow the company's predefined management policy). This is in line with the condition of novelty, whereby it is a condition on which the making of

business decisions cannot be bound by a predefined rule. As demonstrated in the case of *Iesini v. Westrip Holdings Ltd* [502] where the judge refused to second-guess the business judgment of the director because the judges were not equipped to get themselves in considering the commercial factor of which involves 'a great deal more of speculations …' - *Overend Gurney & Co v. Gibb*.[503]

Second, the condition of usefulness (a condition on which the directors' business decision has to be made in good faith in the interest of the company) is reflected in s263(2)(a) of the Companies Act 2006. This retains the old common law rule for the judge to discontinue the derivative action on the ground that the decision to discontinue the legal action was taken by an appropriate independent organ. In other words, a business decision taken by directors in good faith and for the benefit of the company (*Taylor v. National Union of Mindworkers (Derbyshire Area)*[504] and *Smith v Croft (No. 2)*[505]). Section 263(2)(a), the good faith requirement is linked to the duty to promote success of the company under section 172. This forms the basis of which a hypothetical director would believe whether or not the continuing law suit would be in the interest of the company, would much depend on the success rate of the case, the

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[502] [2009] BCC 420, (Ch) [85]
[503] [1872] LR 5 (HL) 480, 495 (as cited by Marc Moore in *Corporate Governance in the Shadow of the State* (Hart Publishing; UK edn, 2012) 155)
[504] [1985] BCLC 237 (HC), 225 (also as cited by Mayson and French and Ryan, Company Law (23rd edn, OUP, 2006-2007) 664
[505] [1988] CH 114 (Ch)

legal cost plus the compensation obtainable (*Franbar Holdings Ltd v. Patel*[506], *Kiani v. Cooper*[507] & *Zavahir v. Shankleman*[508])

SUMMARY

To sum up, by definition, a business decision that is a commercial factor of which the judge is not equipped to second guess, coincides with the condition of **Novelty**; and the legal requirement that the decision must be made in the interest of the company to enable the hypothetical director (acting in good faith) not to pursue an action of negligence, coincides with the condition of **Usefulness**. The definition of Product Oriented Approach of Creativity within the concept of non-programmed decision[509] is the most suitable definition to achieve the objective of showing, from a psychology perspective, that the Companies Act 2006 legislated deference promotes and motivates directors' business creativity (see the relevant section, at the latter part of this chapter, demonstrating the interrelationship between company law's deference and the theories of motivation in psychology).

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[506] [2008] EWHC 1534 (Ch)

[507] [2010] BCC (Ch) [44]

[508] [2016] EWHC 1534 (Ch) (as cited by Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP Oxford, 28th June 2012) 613); See also, *Zavahir v. Shankleman* (2016) EWHC 2772 (Ch) (CH D (Companies CT)) also as covered in Case Comment by an anonymous writer, 'Application for Permission to Continue Derivative Claim Refused' (2016) Co. L.N. 7

[509] Chapter Five is dedicated to the discussion of the psychology and management theory of types of business decisions of programmed and non-programmed nature.

IMPORTANCE OF BUSINESS CREATIVITY/INNOVATION TO COMPANIES

The above section covers the formulation of the appropriate definition of business creativity. This section aims to explore the significance of business innovation to companies. This section represents a significant part of my thesis as it serves as one of the grounding roles to connect to the central argument of this research, i.e., that the element of business creativity or innovation is the central role justifying courts' deferential approach (both in common law and the Companies Act 2006) in favour of company directors. This is so, not just for the benefits of the directors themselves, but more importantly, for the benefits of companies. In other words, to present a successful argument in favour of company law's deference that yields the benefit of motivating company directors in making creative business ideas, one needs to first understand the significance of creativity in the business context.

To begin the discussion on creativity, it is, once again, important to be reminded the understanding of the technical difference between the terms 'creativity' and 'innovation'. Broadly speaking, these two terms are interchangeable as they all refer to one common and essential feature, i.e., creative ideas or inventions. The reason for the terms being used 'interchangeably' within the academic literature as pointed out by De Sousa et al was:

> … because researchers of creativity and innovation come from different backgrounds and failed to make necessary convergence. The field of creativity

> is closer to field of behavioural sciences (like psychology and education) while researchers in the field of innovation come from areas related to the field of management, economics, public administration or political science.[510]

De Sausa et al further agreed with Basadur that there is no difference between creativity and innovation in organisational levels on the basis that they cannot be separated; they carry the same meaning with the same objectives.[511]

For the purpose of this research, the terms - creativity and innovation, will be also used interchangeably in most part of the discussion due to their identical and inseparable features.

Essentially, my proposed concept of Non-Programmed (Creative) Business Decisions will also be regarded as a fusion of two fields of studies, namely, psychology and management as the term (Creative) is based on the definition in the field of psychology whilst, the term Non-Programmed Decision is based on the existing concept in the field of management.[512] As mentioned at the Introduction of this chapter, the external disciplines, namely, economics, psychology and management fields of studies are chosen for this research due to a substantial amount of researches

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[510] De Sousa et al, 'Creativity, Innovation and Collaboration Organizations' (2012) IJOI 1, 2

[511] M.S. Basadur, 'Organizational Development Interventions for Enhancing Creativity in the Workplace' (1997) J Creat Behav 57, (as cited by De Sousa et al, 'Creativity, Innovation and Collaboration Organizations' (2012) IJOI 1, 2)

[512] Although some topics in management overlap with psychology, e.g., the theories of motivation and types of decisions overlap with the behavioural psychology. See for instance, Adrian Furnham, *The Psychology of Behaviour at Work: The Individual in the Organisation* (2nd edn, Psychology Press, 2005) 530

that have been undertaken on the 1. significance of innovation to companies; 2. creativity achieved through motivation; and 3. types of decisions respectively. They are chosen to compensate the lack of the relevant researches in the field of studies of law.

As mentioned in the Introduction of this chapter (ft 415), the issue of lack of research of creativity in law for the purpose of this thesis only refers to creativity within the context of company directors' business decisions and the related company law's deference. The current amount of research that relates to 'law and creativity' is mainly undertaken in the context of intellectual property law.

As the terms, creativity and innovation are now clarified, in the following part, I will focus my discussion on the significance of business creativity to companies.

Toynbee (An American researcher and historian) has pointed out that creativity or innovation is the 'mankind's ultimate capital assets', it is a god-given right to mankind. Thus, withholding or inhibiting creativity would be so serious that it can result in a matter of life and death for any society.[513]

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[513] A. Toynbee, 'Has America Neglected Her Creative Minority?' EPE (1962) 7, 7; see also A. Toynbee 'Is America Neglecting Her Creative Minority?' (1964) EPE as cited by Calvin, ed Taylor, *Widening Horizons in Creativity: The Proceedings of the Fifth Utah Creativity Research Conference*, (1st edn, John Wiley, New York 1964) *9* (as cited by Mark Batey and Adrian Furnham, 'Creativity, Intelligence and Personality: A critical review of a Scattering Literature' (2008) Genet Soci Gene Psychol Monog, 355)

To illustrate the importance for the society to promote creativity or innovation, Toynbee made a comparison between man and other types of organic life forms by pointing out that God has withheld mankind from special attributes of other animal such as ' … the shark's teeth, the bird's wings, the elephant's trunks, and the hound's or horses' racing feet.'[514] He argued that the sense of creativity planted in mankind means that mankind has to perform functions of all the marvelous physical assets that are given to every specimen of non-human life forms. Therefore, any failure to maximize the ultimate resources, i.e., creativity, humans are, in effect, condemning its species into the 'least effective' species on the face of the planet. [515]

F Cainelli, R. Evangelista and M. Savona took the significance of creativity or innovation from economics point of view, they said, 'It is widely acknowledged that technological change and innovation are the major drivers of economic growth and are at the very heart of the competitive process.'[516]; Likewise, Douglas Slater has pointed out that innovation/creativity is a sword that gives 'competitive edge'[517], a survival or success tool in the business world.

Over the past decades, a large amount of economic literatures has been produced to demonstrate the close connection between business creativity and the enhancement of companies' competitiveness. Companies need to be competitive in order to survive in

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[514] A. Toynbee, 'Has America Neglected Her Creative Minority?' (1962) EPE, Inc. 7, 8
[515] A. Toynbee, 'Has America Neglected Her Creative Minority?' (1962) EPE 7, 8
[516] F Cainelli, R. Evangelista and M. Savona, 'Innovation and Economic Performance in Services: a Firm-Level Analysis' (2006) Cam J Econ, 435, 435
[517] Douglas Slater 'Creativity in Organizations' (2001) RSA Journal, 32, 32

a commercially competitive environment. Earlier writer Schumpeter first argued that companies' business competitiveness revolves around innovation, as a creative commercial product would either enable the enterprise to continue competing with its business rivals or achieve a temporary market monopoly which ensures the company a stable stream of revenue to further its advancement in innovative products for future competition.[518]

Researchers such as G.R. James, Pearson, Antonelli and Johnson have argued that as the years have gone by since Schumpeter's postulation of the significance of business innovation, the world has experienced a massive progression in both product sector as well as the 'the rapid development of the service sector, especially finance services'.[519] As a result, many companies' business is no longer restricted within a small locality. Advancement of technologies such as computer and new information technologies have enormously shortened the 'distance' of business markets globally between many countries. Thus, markets have become much more competitive than ever, and requires business creativity as a solution to this increasing level of business competition (Cummings and O'Connell).[520] In other words, and from an overall perspective, companies need -

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[518] J.A. Schumpeter, *Theory of Economic Development: An Enquiry into Profits, Capital, Interest and the Business Circle* (1st edn, HUP, Cambridge M.A 1934)

[519] G.R. James, 'Employers' Organization in the 21st Century' (1997) ILO Publications, 4, 4

[520] Cummings and O'Connell, 'Organizational Innovation' (1978) J Bus Res 6, 33-50 (as cited by Woodman, Sawyer and Griffin 'Towards the Theory of Organizational Creativity' (1993) HUP, 293, 306)

> the ability to respond effectively to new trends and to provide an efficient, personalised service to customers and clients. The transformation of business activities, through technological envelopment, the shorter life-circle of business ideas and products, and the need for new skills require new management strategies and new form of work organisation.[521]

Teresa M. Amabile, a renowned academic writer, has given business creativity a general term by describing the principle as all about 'problem-solving' and the needs to expose company employees including directors to creativity through 'various approaches to problem-solving'.[522] But specifically, she has also been in support of business innovation as an essential element for the success of a business. She has argued that innovation is an absolute and vital element for long-term corporate success. This is because the business world is often volatile, and that the pace of change can be rapidly accelerating. As a result, no company that continues to deliver the same products and services in the same way could long survive. On the other hand, corporations that anticipate through creativity and innovation toward this changing world are much more likely to be successful in both dominating a significant part of

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[521] ibid

[522] Teresa M. Amabile, 'How to Kill Creativity' (1998) HBR, 77, 84

their market shares and being excellent in their cost operations in general[523] by way of having established their unique selling points to the consumers.[524]

One best example of an increase need to business creativity has been indicated by a recent economic report, i.e., Oslo Manual. Oslo Manual states that innovation allows the firms to get 'a monopoly position due either to patent (legal monopoly) or to the delay before competitors can imitate it. This monopoly position allows the firm to set a higher price than would be possible in a competitive market'[525] thereby enhance the company's profitability.

However, the success of this market monopoly position will significantly depend on the life-circle of the business product or ideas as indicated by Oslo Manual that 'New technology competes with established ones and in many cases replace them.'[526] The competitive threat from business rivals has been further intensified, 'because it is possible today to replicate quality almost anywhere in the world.'[527] This had been

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[523] Teresa M. Amabile 'Motivating Creativity in Organisations: On Doing What You Love and Loving What You Do' (1997) Calif Manag Rev 39, 40

[524] Articles pointing out the danger of both UK and US companies, in focusing on increasing company share values, based on short-term equity market incentives, at the expense of optimal successes founded on long-term innovation investments, included Sir George Cox, 'Overcoming Short-termism within British Business – The Key to Sustain Economic Growth', (An Independent Review Commissioned by Labour Party 2013) para. 54; Allan G Hallsworth, 'Short-Termism and Economic Restructuring in Britain' Econ Geogr (1996) 35; N. Tanden & B. Efron, 'How to Foster Long-Term Investment' (2015) <http://www.globalpolicyjournal.com/blog/12/07/2015/how-foster-long-term-innovation-investment > accessed 17th November 2017; and Roger L Martin, 'Yes, Short-Termism Really is a Problem' (2015) HBR <https://hbr.org/2015/10/yes-short-termism-really-is-a-problem> accessed 17th November 2017

[525] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn, Eurostat*, European Commission 2005)* 16

[526] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn, Eurostat*, European Commission 2005)* 16

[527] G.R. James, 'Employers' Organization in the 21st Century' (1997) ILO Publications, 4, 4

agreed by academic writers, for instance, Segerstrom, who had stated that, 'Firms invest significant resources in research and development activities to discover qualitatively imposed products and capture associated profits. When they are successful, other firms, attracted by these profits, imitate, and thus they accelerate the development and production of new products.'[528] This means that on the one hand, small companies are gaining the edge of competitiveness through either simple copies or creative ideas based on an existing originality, but on the other hand, directors working for the companies in the temporary market monopoly position are increasingly facing the needs to make quick and decisive creative business decisions in order to satisfy the global business market where 'the competitive differentiation will come from swiftness to the market and innovation.'[529] As Segestrom has said that, 'Other firms devote resources to imitate new superior products, and successful innovations cannot count on earning dominant firm profits forever. Because of product innovation, individual products eventually become obsolete.'[530]

Over the years, the significance of business innovation and its connection to business competition through the ability to respond swiftly to the market trends have been widely promoted by countries. For instance, the Australian government in its business guide to investors, has recently encouraged companies to not just having the ability only, on operating the business, for the current markets. But, more importantly, the

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[528] Paul S. Sergerstrom, 'Innovation, imitation, and Economic Growth' (1991) J Political Econ, 807
[529] G.R. James, 'Employers' Organization in the 21st Century' (1997) ILO Publications, 4, 4
[530] Paul S. Sergerstrom, 'Innovation, imitation, and Economic Growth' (1991) J Political Econ, 807, 826

ability to adopt to the needs of swift innovation, i.e., the ability to anticipate the likely trend in the future among consumers and thereby create 'an idea product or service to meet the future demand rapidly and effectively'.[531]

Prior to 2002, the American Council on Foreign Relation has asserted that over the past many decades, the US has managed to amass a disproportionate share of the world's wealth because of its relentless pursuit of business and product creativity. This is demonstrating that business innovation is 'a central catalyst of steady economic performance.' [532] Ahlstrom also argued in 2010, that:

> … as recently as little more than a century ago, the purchasing power of an American was one tenth of what it is today; the United States and several other countries have experienced sustained economic growth over the past two centuries, while others lagged considerably … The salience of growth is evident in that well-managed, growing firms can do much more for their employees and customers.[533]

The survival and the success of the US companies, in Ahlstrom's view, had been achieved because 'The firms bring to the market cutting-edge and novel innovations,

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[531] Queensland Government, 'Queensland Government Business Guide for Investors', (Business and Industrial Portal 2015) <https://www.business.qld.gov.au/business/business-improvement/becoming-innovative-business/why-business-innovation-important> accessed 16th July 2016

[532] B. Steil, G.D. Victor & R.P. Nelson, *Technological Innovation and Economics Performance. A Council on Foreign Relations Book* (1st edn, A CFR Book. Princeton University Press, 2002)

[533] David Ahlstrom, 'Innovation and Growth: How Business Contributes to Society' (2010) AOM 11, 12

which in turn create new business growth while delivering novel goods and services to the market place.'[534]

Ahsltrom's view on significance of innovation was recently echoed by Professor John Kay in his 2012 report, where he described business innovation to companies as 'the source of their competitive advantage[535]'. Kay stated that some companies have the tendency of adopting short-termism approaches at the expense of the development of the company's 'capacity for innovation'[536] – 'a decision that we subsequently regret'.[537] Labour Party's 2013 Report of which the former institute of Directors boss, Sir George Cox, said that the UK companies have become primarily focused on shorter term gain at the expense of long term Research and Development (R & D) which has the consequence of 'impairing the development of international UK competitive businesses.'[538] He further said that this problem of short-termism must be addressed, otherwise, 'the UK will inevitably fall behind not just the rapidly developing economies, but also its traditional competitors.'[539] The decline of the British economy as a result of the corporate or financial system that 'are geared to the

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[534] ibid

[535] Professor John Kay, 'The Kay Review of UK Equity Markets and Long-Term Decision Making' (2012) Final Report, 14 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf > accessed 6th March 2019

[536] ibid

[537] ibid

[538] Sir George Cox, 'Overcoming Short-termism within British Business – The Key to Sustain Economic Growth', (An Ind Rev Com by Labour Party 2013) para. 54

[539] Sir George Cox, 'Overcoming Short-termism within British Business – The Key to Sustain Economic Growth', (2013) (An Ind Rev Com by Labour Party 2013) para. 54

vagaries of short term success …' had also been mentioned by Professor Hallsworth.[540]

The UK is not the only country that suffers from the problem of corporate short-termism. The necessity of companies avoiding short-termism, and the significance of companies continuously fostering long-term innovation investments, have in recent years, been pointed out by Tanden and Efron. Stating that the recent shift of corporate focus amongst American companies on raising their share values by achieving short-term corporate targets, yielding quick return to investors at the expense of R & D will be against the companies (or even the US economy as a whole) in the long run.[541] This is supported by 2015 survey undertaken by National Science Foundation - Division of Science Resources Statistics which has revealed that the US companies have been gradually focusing less on basic scientific R&D. This, according to President Obama, may have negative impact on the US Economy in long run.[542] The danger of corporate short-termism to the US economy is also being echoed by academic writer Roger Martin of Toronto University in his recent article.[543]

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[540] See generally Allan G Hallsworth, 'Short-Termism and Economic Restructuring in Britain' Econ Geogr (1996)

[541] N. Tanden & B. Efron, 'How to Foster Long-Term Investment' (2015) <http://www.globalpolicyjournal.com/blog/12/07/2015/how-foster-long-term-innovation-investment > accessed 17th November 2017; see also Roger L Martin, 'yes, Short-Termism Really is a Problem' (2015) HBR <https://hbr.org/2015/10/yes-short-termism-really-is-a-problem>

[542] Brad Plumer, 'American Companies are Investing Way Less in Science Than They Used To' (Vox Technology 2015) < http://www.vox.com/2015/2/4/7965967/corporate-research-basic-science> accessed 16th July 2016

[543] Roger L Martin, 'yes, Shor-Termism Really is a Problem' (2015) HBR <https://hbr.org/2015/10/yes-short-termism-really-is-a-problem>

Indeed, empirical evidence around the world has repeatedly proven that business innovation represents an indispensable key to a company's success and economic growth. For instance, business innovation explains much of the GDP (Gross Domestic Products) growth in China from 1981-2004 through its aggressive pursuit of research and development (R&D) for technological, organisational and service innovation.[544]

One reason for this positive link, as asserted by Ahlstrom, is that innovation promotes new product and services which generate economic growth as a result of the constant increase of demand for them by the society due to the beneficial features of these products and services.

As concluded by Ahstrom, 'Profits do matter. But good firms supply far more than just profits for their owners: they bring innovation into the market, which in turn provide economic growth, employment, and significant improvements to people's lives.'[545]

Apart from Ahlstrom, this school of thought where business innovation leads to competitiveness, then followed by economic growth to the society and finally positively benefits back to the company is shared by many other academic writers,

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[544] See Peilei F, 'Innovation Capacity and Economic Development: China and India' (2011) Econ Change Rest 44 (2/1) 43

[545] David Ahlstrom, 'Innovation and Growth: How Business Contributes to Society' (2010) AMJ , 11, 11

such as Arthur[546], Barro & Sala-i-Martin; and Baumol & Strom.[547] These writers have placed much emphasis on success of companies based on business creativity and argued that if the society hinders or 'de-motivate' the companies from innovation, the consequence can be devastating not only to the companies themselves but to the growth of the economy as a whole. In other words, there is a close relationship based on **mutual benefits** between the companies and the countries that they are benefiting.

Academic writers Pfeffer, as well as, Hammel further argued that business creativity depends on the talented employees but when facing a creatively competitive market, these employees will only be willing to continue to stay with the company if the company continues to exhibit the willingness to innovate and operates within the creative framework. This is because people do not want to have years of their lives wasted in a less creatively competitive company where its potential business advancement is constrained with no or little prospect of pay rise. In comparison, creative companies tend to offer competitive job package in order to attract talent; and have higher potential of giving better pay to the employees.

In addition, as with directors having intrinsic motivation to seek business creativity, a company willing to embrace innovation are more likely to offer those directors a job environment with enhancement of their intrinsic motivation that leads to job

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[546] Arthur Lewis, 'Competing technologies, Increase Returns, and Lock-In by Historical Events' (1989) EJ. Vol 99, No 394

[547] Barro & Sala-i-Martin, *Economic Growth* (Cam. M.A. The MIT Press 2004); and Baumol & Strom 'Entrepreneurship and Economic Growth' (2007) SEJ (both cited by David Ahlstrom, 'Innovation and Growth: How Business Contributes to Society' (2010) AMJ 11, 11)

satisfaction.[548] Therefore, when a company continues to lose its creative competitiveness, many of the most capable employees (including directors and other key employees) will be head-hunted by the company's rivals. This vicious circle will continuously affect the company's 'ability to re-generate growth'.[549]

It follows that, business innovation has the advantage of motivating the company's employees to participate its activities, thus making them to be more active and loyal to the company.[550] As Cox and Blake have said that, 'Constantly innovating and improving business practices is also likely to help you attract better staff members and retain more of your existing staff – something which is crucial to the long-term health and performance of your business'.[551]

Oslo Manual is in support of this argument by arguing further that business innovation 'has led to a better appreciation of the importance of the conditions, regulations and policies within which markets operates – and hence the inescapable role of governments in monitoring and seeking to find-tune this overall

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[548] More information regarding directors' intrinsic motivation to creativity and how the current UK company law serves as a motivator from psychology perspective will be discussed in details at the latter part of this chapter

[549] Gary Hamel, 'Bring Sillicon Valley Inside' (1999) HBR, 70; and Jeffrey Pfeffer, *The Human Equation: Building Profits by Building People First*, (Boston: Harvard Business School Press, 1998) (both as cited by David Ahlstrom, 'Innovation and Growth: How Business Contributes to Society' (2010) AOM, 11, 13)

[550] Queensland Government, 'Queensland Government Business Guide for Investors', (Business and Industrial Portal 2015). https://www.business.qld.gov.au/business/business-improvement/becoming-innovative-business/why-business-innovation-important. accessed 16th July 2016

[551] See also Taylor H. Cox and Stacy Blake, 'Managing Cultural Diversity: Implication for Organisation Competitiveness' (1991) EJ, 46, 50

framework.'[552] This economic argument can also be manifested (and to repeat what has been previously emphasized in this thesis) in support of the current Companies Act 2006 promoting directors' business creativity based on the discontinuation of derivative action in the interest of the company.

As the central argument of this thesis, the 2006 Act that excludes any improper legal intervention, either intentionally or unintentionally, aims to prevent company directors from being risk adverse in business creativity. From a psychology perspective, as argued by this thesis, the absence of such legislate deference within duty of care liability regime will either result in directors from refusing to accept the directorship[553] or (as argued by Canard) directors exercising 'care' or due diligence only to protect themselves rather than achieving business growth through creativity. For instance, directors taking 'care' to keep up long and unnecessary records and trails of papers justifying their business decisions or seeking external consultations where in the situation would be unnecessary to do so which inevitably cause delay to or miss the business opportunity.[554] This mal-practice can also, in many situations, incur unnecessary expenses to the company.[555] Directors' risk adverse behaviour is

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[552] *Organisation for Economic Co-operation and Development, Oslo Manual*, (1st edn, Eurostat, European Commission 2005*)* 17

[553] See for instance, Annete Greenhow, 'The Statutory Business Judgment Rule: Putting the Wind into Directors' (1999) *Sails'* BondLawRw, 33, 42; Keneth E. Scott, 'Corporation Law and the American Law Institute Corporate Governance Project' (1982-1983) 35 Stan Law Rev, 927, 936; see also Julian Velosco, 'Structural Bias and the Need for Substantive Review' (2004) Wash Univ Law Rev, 913, 917

[554] Alfred F. Conard, 'A Behavioral Analysis of Directors' Liability for Negligence' (1972) Duke L J, 904

[555] Alfred F. Conard, 'A Behavioral Analysis of Directors' Liability for Negligence' (1972) Duke L J, 904

due to the factors, as Segerstrom has suggested, that business innovation can be costly, time- consuming and involves **uncertainty**.[556]

This is connected to the conclusions in Chapters Two and Three that, similar to US business judgment rule, the UK law (as shown in both common law and Companies Act 2006) recognizes, by way of deferential approach, the uncertainty and uniqueness of directors' business judgment or Non-Programmed (Creative) Business Decisions (*Overend Gurney & Co v. Gibb*[557]; and *Kleanthous v. Paphitis*[558]) while retaining the legal intervention (through the codification of the common law into the 2006 Act) on directors' programmed business decisions, i.e., directors' business decisions of which the assessment of the related duty of care can be achieved through certain predefined rules, such as the company's internal control policy (*Re Baring plc (No. 5)*[559]).

Concerning motivation, this chapter will, on the sub-section below, demonstrate that the law offers deference insulating company directors from derivative lawsuit in the context of their Non-Programmed (Creative) Business Decisions/business judgment. Judicial or legislated deference, according to psychology studies, have direct contributions to directors' intrinsic motivation in creativity. In other words, the section dealing with motivation in this chapter will demonstrate that the UK law is legislated very much in line with the theories of motivation in psychology, in the

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556 Paul S. Segerstrom, 'Innovation, imitation, and Economic Growth' (1991) J Political Econ, 807, 826
557 LR 5 (HL) 480, 495
558 [2011] EWHC 2287 (Ch) [71], [72]
559 [1999) 1 BCLC (CA) 433

sense that deferential approach under the 2006 Act facilitates directors' intrinsic motivation which promotes directors' business creativity.

Finally, business innovation that results in macroeconomic (economic system in large scale) growth is not only achieved through companies and firms competing with each other; or companies' business innovation benefiting the people. It is also about companies forming an alliance to create business innovation through the processes of technological infusion involving 'incremental improvement both to new and established technologies'[560]. This mutual advantage and support between the companies, either among the competitors or producers and suppliers create mutual or macro-economic growth.[561] Therefore:

> … it provides a foundation on which wealth can be accumulated by more and more people over a prolonged period of time, innovation can mitigate conflicts among different interest groups over the allocation of resources and returns: an increase in the living standard of one interest group does not have to come at the expense of another.[562]

And hence, promote growth of economy as a whole.

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[560] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn, Eurostat, European Commission 2005) 16

[561] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn, Eurostat, European Commission 2005) 16

[562] Mary O'Sullivan, 'The Innovative Enterprise and Corporate Governance' (2000) Camb J Econ, 393, 393

In this section, I will use five law cases from both English and American legal jurisdictions[563], to give an insight as to how business innovation in the context of directors' business decisions impacts positively to the financial and economic interest of the company. As the chosen cases are law cases which the writer of this thesis was not a party, the writer had no influence to the development or the outcome of the cases. These five cases have been selected randomly within the pool of cases where the contextual conditions are relevant to the economics theories discussed above, specifically ranging from:

- The preservation of the company's business competitiveness through business creativity either secured by intellectual property right or business investment;

- Promotion of macro-economy growth, thereby benefits the company, e.g., business creativity as resources being allocated between different companies leading to the achievement of further business creativity, with an aim to benefit the companies financially in 'partnership' from a macroeconomics perspective[564];

- Cost-saving or effective cash-flow; and

[563] Together they serve as an analytical framework suitable for the jurisdictional background of this thesis

[564] Macroeconomics is referring to the behavior and structure of economy as a whole for instance economy regionally, nationally or globally. O'Sullivant et al, *Economics: Principles in Action* (Prentice Hall; Student edn, 2006) 57

- Promotion or maintenance of the values of the company's assets, i.e., effective management of its property portfolio.

Business innovation covers vast areas of business activities, ranging from product innovation through legal protection of copyright and patent to organisational innovation, which include company directors' business decisions in negotiating with external parties for procurement of contracts of products or services. For instance, a real estate overage agreement.[565]

However, majority of successful business creative decisions do not end up in legal dispute. Therefore, there is a limitation on how case law can offer to bring out the true essence of the benefits of business innovation. In addition, as already mentioned earlier on in this chapter, psychology and management also do not offer sufficient analysis into the economic benefits of the significance of business innovation to companies. As explained in the latter part of this chapter, the relevant researches are primarily focusing on the psychology and the management aspects of creativity/innovation. Both in the formulation of the definition of creativity & motivating creativity; and, as Chapter Five will cover, types of business decisions. The limitations in psychology and management explain why economics needs to be relied upon in this research for the studies of significance of business innovation.

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[565] See for example, case study three - *Hildron Finance Limited v. Sunley Holdings Limited* [2010] EWHC 1681 Ch

Now going back to the law, as briefly mentioned above, most of the law cases that directly involve the question relating to directors' Derivative claim case – duty of directors to act in their powers, contained in section 172 Companies Act 2006, do not fully portrait the significance of what business innovation can bring to a company. These cases are, as the nature of law suit suggests, primarily involving the issues on: 1. whether or not there was a creative business decision; 2. was such a decision made bona fide in the interest of the company; and 3. was such a decision made by the director as an appropriate independent organ of the company. For instance, in the case of *Smith v Croft (No.2)*[566] where the court showed diffidence to interfere with the director's business decision on the basis of a decision being a Non-Programmed (Creative) Business Decision/business judgment made by the director, acting as an appropriate independent organ of the company; and in the case of *Kleanthous v. Paphitis*[567] where the court once again, refused to second-guess the directors' business judgment on the basis that only the director (as opposed to the court), who is an appropriate independent organ of the company is equipped to make bona fide Non-Programmed (Creative) Business Decisions.

In addition, derivative law suit usually occurred because the company suffers or is allegedly suffering from a financial loss as a result of the company directors' business decision gone wrong. Consequently, derivative law suit cases do not usually bring out

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[566] [1988] Ch 114, (Ch) [184]
[567] [2011] EWHC 2287 (Ch) [73], [75]

the best picture of business innovation. In other words, they do not effectively demonstrate the economics benefits mentioned in this section. Any benefit of innovation out of breach of duty of care cases tend to be speculative[568] (For instance, in *Overend Gurney & Co v Gibb*[569] the judge ruled that company directors were not liable for his business decision because the decision made in a mercantile world is full of speculation with 'readiness to confide in the probabilities of things'[570]; or in *Iesini v Westrip Holdings Ltd* [571] where the court refused to second-guess the commercial decisions of the directors due to the uncertainty in relation to the outcome of the commercial decisions).

Or in certain law cases, where the court acknowledged the legality of the business decision exercised by the directors as an appropriate independent organ of the company, but held that the directors' decision was made for an improper purpose. Thus, rendering any economic benefit to the companies speculative. For example, in company takeover bid cases such as *Hogg v Cramphorn Ltd*[572]*; Howard Smith Ltd v. Ampol Petroleum Ltd; and Extrasure Travel Insurances Limited v. Scattergood and Others*[573]

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[568] Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 171
[569] [1872] LR5 (HL) 480, [480], [495]
[570] ibid
[571] [2009] BCC 420 (Ch) [85]
[572] [1967] Ch 254 (Ch)
[573] [2002] 1 BCLC 598 (Ch) [90], [97]

The following case studies 2 and 5 involved actions for breach of duty of care against the directors leading to speculative benefits to the companies, i.e., these cases involved the courts' acceptance of the business decisions based on the principles that the decisions were made in the interest of the companies; and the courts were not in the position to second-guess the business creativity of the directors. To overcome the limitation resulted by the speculative nature relating to the economic benefits of which the company might ultimately enjoy, I have also selected three other cases which are not fundamentally concerning breaches of duties of care cases. The advantage of these cases is that the cases' outcomes have articulated the clear, non-speculative benefits to the companies concerned. Thus, offer clear and direct perspectives linking to the importance of business innovation to companies - generally discussed in this chapter.

It is important to note that due to the sequential development of Chapters Four and Five of this thesis, the purpose of the current case studies is not to show whether or the directors' business decisions fits into the proposed definition of creativity, or as this thesis would call it, Non-Programmed (Creative) Business Decision. The following case studies are simply conducted to demonstrate the benefits of creativity to companies. The direct and indirect case studies, including the revisiting of the cases in this case studies, demonstrate whether or not a particular business decision constitutes a Non-Programmed (Creative) Business Decision will be undertaken in

Chapter Five, where all the elements of business creativity underpinned by the concepts of types of business decisions are fully covered.

CASE STUDY NO. 1: *SAMSUNG ELECTRONICS (UK) LIMITED V APPLE INC.* [2012] EWHC

Facts: Since the launch of first I-phone in 2007, Apple Inc. enjoyed a massive market success over its product innovation. Apple protected its legal position regarding its product creativity through registrations of a large number of design patents, registered trademarks and trade dress rights. In 2011, Apple filed a global law suit against Samsung Electronics Co. Samsung Electronics Co was the rival and the then acting component supplier of Apple for a number of alleged infringements of intellectual property rights owned by Apple. Apple claimed that several of Samsung's Android phones and tablets had infringed its patents, trademarks, user interface and style.[574] Samsung denied the allegations, and in 2011, filed a counter-claim against Apple for infringement of Samsung's patent for mobile telecommunication technology.[575]

As part of the ongoing global law suits on intellectual property infringement between the Apple Inc and Samsung Electronics Co (the two corporate giants who own

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[574] See Kane et al, 'Apple: Samsung Copied Design' (2011) (The Wall Street Journal, Dow Jones and Company) <http://www.wsj.com/articles/SB10001424052748703916004576271210109389154> Accessed 16th July 2016

[575] Erik Larson, 'Samsung Sues Apple in UK Following US Iphone Patent Suit' (2001) (Bloomberg Business Week, Bloomberg) <http://www.bloomberg.com/news/articles/2011-06-30/samsung-sues-apple-in-london-following-u-s-iphone-ipad-patent-lawsuit.> Accessed 16th July 2016

disproportionate market shares in the Information Technology and smart-phone market). Samsung in 2012, sought a declaration from the UK High Court that 'three of its Galaxy tablets computers (the Tab 10.1, Tab 8.9 and tab 7.7) do not infringe. Apple counter-claims for infringement.'[576]

Despite Apple's counter-claim, Samsung successfully obtained the declaration after Judge Birss ruled in favour of Samsung. In the judgment and in particular, the distinctive innovation between iphone and Samsung, his honour said:

> The extreme simplicity of iphone design is striking. Overall it has undercoated flat surfaces with a plate of glass on the front all the way out to a very thin rim and a blank back. There is a crisp edge around the rim and a combination of curves, both at the corners and the sides. The design looks like an object of the informed user would want to pick up and hold. It is an understated, smooth and simple product. It is a cool design.[577]

And in the judicial conclusion based on the overall impression compared, his honour said:

> The informed user's overall impression of each of the Samsung Galaxy Tablets is the following. From the front they belong to the family which includes the Apple design; but the Samsung products are very thin, almost insubstantial

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[576] *Samsung Electrics (UK) Ltd V Apple Inc.* [2012] EWHC (Ch) [1]
[577] ibid [182]

> members of that family with unusual details on the back. They do not have the same understated and extreme simplicity which is possessed by the Apple design. They are not as cool. The overall impression produced is different.[578]

In concluding the case, His Honour Judge Birss stated that 'The Samsung Tablets do not infringe Apple's registered design No. 000181607-0001.'[579]

Comment: This case demonstrates Point 1 of the economic benefits, i.e., the preservation of the company's business competitiveness through business creativity secured by intellectual property right. As mentioned in the earlier part of this chapter, that business innovation enables the company to achieve market monopoly coupled with the legal protection through intellectual property registration, the life-circle of innovative products is maintained for a period of time. Indeed, Apple's creative business decision in its tele-communication technology contributed massively to the existence of today's 'Apple Kingdom'. However, also as discussed in the previous section, that the competitive threat from business rivals is now aggravated, 'because it is possible today to replicate quality almost anywhere in the world.'[580] Therefore, the rival companies, (Samsung in this case) can, in my opinion, be said to have gained the edge of competitiveness through creative ideas based on an existing originality.[581] As indicated by Oslo manual that 'a firm may take a reactive approach (Samsung under

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[578] ibid [190]
[579] ibid [191]
[580] G.R. James 'Employers' Organization in the 21st Century' (1997) ILO/OIT, 4, 4
[581] ibid

the present case) and innovate to prevent losing market shares to an innovative competitor (Apple under the present case).'[582]

Business creativity has contributed to the great business success of both companies. The success of Apple was based on business innovation; and Samsung has won many law suits on intellectual property right against Apple because of Samsung director's business judgment to invest in the products that demonstrates the novelty of its products by way of business innovation.

This case also demonstrates Point 2 of the economic benefits, i.e., Business creativity as resources being allocated between different companies leading to completion of further business creativity with an aim to benefit financially to the companies in 'partnership' from macroeconomics perspective. On the macroeconomic growth side, (as briefly mentioned in the facts section above) despite this legal dispute, Samsung continued to act as a key part supplier for the innards of the iphones and ipad lines.[583] The business relationship between the parties had started both before the commencement of the alleged intellectual property right infringement legal proceedings and continued even during the process of the litigation. It is reported that a former Apple executive has said that:

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[582] *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn, Eurostat, European Commission 2005) 16

[583] Zac Hall, 'Samsung Remains as a Key Supplier for Apple's Iphone Despite Patent Dispute, Competition' (9TO5MAC 2015) <http://9to5mac.com/2015/02/24/samsung-apple-iphone-supplier/> accessed 16th July 2016

> Samsung is the world's biggest maker of some of the most sophisticated parts that Apple craves, such as processors, memory and high-resolution screens. Apple also has more than a half-decade invested in working with Samsung to build custom chips. Replicating that elsewhere is daunting.[584]

Samsung's business innovation on its component products has limited Apple's choices for a number of years. This is a classic example of resources allocation to achieve an innovation process, where the directors of a number of companies had made business decisions to form alliance with each other in order to implement business creativity with the benefit of boosting up the level of international trade.[585] And in turn, benefits the economy through which ultimately benefits the companies themselves.[586]

CASE STUDY NO. 2: *DODGE V FORD MOTOR CO* 170 NW 668 [MICH 1919] [587]

Facts: Henry Ford - the company director of Ford car manufacturing company decided to re-invest the company profits into developing a number of plants and

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[584] Lessin J.E. 'Apple Finds It Difficult to Divorce Samsung' (The Wall Street Journal, July, 2013) < http://www.wsj.com/articles/SB10001424127887324682204578513882349940500> accessed 16th July 2016

[585] *Organisation for Economic Co-operation and Development,* Oslo Manual, (1st, Eurostat*, European Commission 2005)* 16; See also in general Huang. Y, 'Debating china's Economic Growth: The Beijing Consensus or the Washington Consensus?' (2010) Acad Manag Perspect, 31, 47

[586] *Organisation for Economic Co-operation and Development,* Oslo Manual, (1st, Eurostat*, European Commission 2005)* 16; See also in general Huang. Y, 'Debating china's Economic Growth: The Beijing Consensus or the Washington Consensus?' (2010) Acad Manag Perspect, 31, 47

[587] See also Robert Hamilton, Corporations including Partnership and Limited Partnership, Cases and Materials (2nd, West, 1981) 816

machinery in anticipation of an increase car sale in the future. This business decision was made at the expense of withholding dividends from the shareholders.

The company shareholders were not happy with the director's business decision, brought an action against the director for breach of duty of care and loyalty relating to shareholder wealth maximization on which under the one roof - both breaches of duty of care and loyalty overlapped. Consequently, being the instruments claimed against the director.[588] During the ruling, the judge commented that it was not within the capability of the judge to conclude whether or not the director's forecast of a massive increase of the company sale in the near future was accurate.[589] However, it later turned out that the director's forecast was correct and that the acquisition of the additional plant and machinery were indeed the correct business move to meet a rise in the number of cars within the company's production-line as a result of an increase in the consumers' demand.

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[588] Bernard S. Sharfman, 'Shareholder Wealth Maximization and its implementation under Corporate Law' (2007) FLA. LAW. REV. 386, 391; see also, Ewoud Hondius & Andre Janssen, Disgorgement of Profits: Gain Based Remedies Throughout the World (1st edn, Springer International Publishing, 2015) 438; see also J.R. Macey, 'A Close Read of an Excellent Commentary on Dodge v. Ford' (2008) Va. L. & Bus. Rev. 177, 178 where Mackey pointed out that had not the director stupidly admitted that he was making the business decision not in the best interest of the shareholders, the shareholders would not have succeeded the claim on the ground of breach of loyalty to maximize their wealth, as it would not be possible to show a breach of such a duty in the case because investment of dividends for long term gain could also constitute shareholders' wealth maximization. This leads us back to the following articles regarding companies focusing on short term gain as the expense of long term investment (see Sir George Cox, 'Overcoming Short-termism within British Business – The Key to Sustain Economic Growth', (An Ind Rev Com by Labour Party 2013) 54; Allan G Hallsworth, 'Short-Temism and Economic Restructuring in Britain' Econ Geogr (1996) 35; N. Tanden & B. Efron, 'How to Foster Long-Term Investment' (2015) <http://www.globalpolicyjournal.com/blog/12/07/2015/how-foster-long-term-innovation-investment > accessed 17th November 2017; and Roger L Martin, 'Yes, Short-Termism Really is a Problem' (2015) HBR <https://hbr.org/2015/10/yes-short-termism-really-is-a-problem>

[589] Robert Hamilton, Corporations including Partnership and Limited Partnership, Cases and Materials (2nd edn, West, 1981) 816

As part of his defense, the director claimed that the business expansion also yielded the benefit of employing, 'more men, to spread the benefits of this industrial system to the greatest possible number …'

The court refused to hold the director liable for breach of duty of care against the company for the proposed expansion of the business on the ground of business judgment or, from a psychology perspective, Non-Programmed (Creative) Business Decision of the company director.[590]

Comments: This case demonstrates the benefit mentioned earlier, i.e., the preservation of the company's business competitiveness through business creativity through long-term business investment; and another benefit also mentioned earlier, i.e., promotion or maintenance of the values of the company's assets, i.e., effective management of property portfolio.

The company director's proactive approach to gain strategic market position against the company's competitors, through his forecast of a rise in demand for Ford's cars in the near future. This business decision is implemented by investing the profits to further the research and development of the company's products. This is important, as the continuing supply of the company's products will maintain customer loyalty and prolong the life span of the company's products through research and development

[590] *Dodge v. Ford Motor Co* 170 n.w. 668, 684 [Mich. 1919]; see also Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57, Vand L Rev 83, 98

for further innovative technology, thus ensuring the continuation of the company's market monopoly or competitiveness. These economic benefits to the company were also recognized by the court.[591]

This case also demonstrates the benefit mentioned earlier, i.e., Promotion of macro-economy growth, thereby benefits the company. The director of the company also claimed that the proposed business expansion would help the economy by increasing the employment rates of the country. This argument is in line with the economists' assertion that business innovation results in macro-economy growth and which would eventually benefit the company through an increase of consumers' ability to spend with an up rise in demand for the products and services. It can therefore be argued from the perspective that, this economic interpretation, in turn, supports the legal concept as mentioned by Macey in his review and commentary on the case, that the director has managed the company to maximize the profits of the shareholders.[592]

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[591] *Dodge v. Ford Motor Co*. 170 n.w. 668, 684 [Mich. 1919]; for the significance of companies' long-term innovation investment, see N. Tanden & B. Efron, 'How to Foster Long-Term Investment' (2015)
<http://www.globalpolicyjournal.com/blog/12/07/2015/how-foster-long-term-innovation-investment > accessed 17th November 2017

[592] J.R. Macey, 'A Close Read of an Excellent Commentary on *Dodge v. Ford*' (2008) Va L & Bus Rev, 1384

CASE STUDY NO. 3: *HILDRON FINANCE LIMITED V SUNLEY HOLDINGS LIMITED* [2010] EWHC 1681 (CH)

Facts: In 1986, the directors of the seller company sold a large block of flats. The relevant contract of sale contained a provision for the overage payment. This provision provides that a share fifty percent proceeds of sale to be paid to the seller company upon the subsequent sale of the porter's flat with two pre-conditions to be satisfied: 1. when the porter's flat was no longer required to accommodate a resident porter; and 2. that the flats were sold in an open market.

The Leasehold Reform Housing and Urban Development Act 1993 came into force after the sale which allowed the tenants of the flats to acquire the flats by way of collective enfranchisement rights. When the porter flat ceased to be occupied by the resident porter, the tenants exercised their right under the new law which prevented the seller company from selling the flats in the open market, thereby rendering the overage provisions void. The freehold of the porter's flat was transferred to the tenants at a price of twenty thousand pounds, one third lower than that of the price that could have been obtainable in the open market; but fifty percent higher than the original price when the flat was sold in 1986.

Because the original buyer was no longer liable to pay the overage to the seller. The overall calculation of profits meant the original buyer did not have to pay 50% of the sales proceeds to the seller had the porter's flat being sold in the open market. The Buyer was over £71,917.00 better off without the overage being paid out.

No issue of directors' negligence was raised in this case. The court had to decide whether or not it is willing to re-construct the overage provision in the seller's favour by setting aside the requirement of the Leasehold Reform Housing and Urban Development Act 1993.

Comments: This involves the parties in the property disposal having entered into an agreement containing the words – "open market" as a condition to operate the overage provisions in the contract. Thereby, resulted in the seller company not gaining the overage payment when the subsequent change of law allowed the purchaser to sell the property outside of the open market.

This case demonstrates the benefits previously mentioned, namely, cost-saving or effective cash-flow; and promotion or maintenance of the values of the company's assets, i.e., effective management of property portfolio. As a general principle of overage mechanism, this case demonstrates the importance of organisational creativity in the sense that the business innovation manifested through the overage agreement represents an innovative business policy relating to the business relationship with external business counterpart.[593] Although overage represents a general concept of property disposals that links to potential future investment, each

[593] Gunday et al, 'Effect of Innovation Types of Firm Performance', (2009) 1, 4 <http://research.sabanciuniv.edu/13660/1/Gunday_et_al_Effects_of_Innovation_on_Firm_Performance.pdf> accessed 16th July 2016. See also *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st end, Eurostat*, European Commission 2005)* (also cited by Ginday et al in the above article)

overage mechanism is a Non-Programmed (Creative) Business Decision. This is so because such type of business decision is uniquely and creatively designed to bring mutual benefits for both buyers and sellers in their particular circumstances. In this case, the buyer was able to acquire the property with a good price, thereby achieved cost-saving/effective cash-flow. In turn, the buyer promised contractually to pay an extra value of the property through subsequent sale of the property that mutually benefits both parties. When the buyer's overage liability was frustrated by the introduction of the 1993 Act, the buyer made a Non-Programmed (Creative) Business Decision to legally deny that the overage provision in the agreement had been triggered.[594] Consequently, the buyer was allowed to keep all the sales proceeds. As the judge said in the case that the overage provision had been agreed 'with the agreed steps to be taken in that event both narrowly and prescriptively formulated'.[595]

On the other hand, the selling company did not obtain the overage payment due to the restrictive drafting of the provisions in the overage agreement, it nevertheless, represents the typical business innovation situation involving 'trial and errors' with the necessity to undertake business risk for future success. As Lord Wilberforce and Lewison J have respectively concluded in *Howard Smith Ltd Ltd v. Ampol Petroleum Ltd;* and *Iesini v. Westrip Holdings Ltd* that the courts have no jurisdiction to judge

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[594] *Hildron Finance Ltd v. Sunley Holdings Ltd* [2010] EWHC 1681 (Ch) [37]
[595] Ibid [37]

'the correctness in the quality of' a business judgment;[596] and are 'ill-equipped' to assess the quality of a business judgment.[597]

Even though, the business project between the parties can hardly bring the positive effect on the macro-economy due to the considerable small scale of the project. This case, nevertheless, demonstrates the economic benefits of allocation of resources through innovation process by way of the specific overage provisions. Such business creativity helps to bring the buyer's funds and the seller's property together working towards the achievement of a common creative objective, i.e., the future growth in the property investment.[598]

CASE STUDY NO. 4: *BOWMAN V MONSANTO CO*. 596, U.S. [2013]

Facts: Monsanto Co had created transgenic soybeans which placed itself in a market monopoly position.[599] In an attempt to continue dominating the market, Monsanto registered a patent protecting its exclusive legal right in producing the transgenic beans. The Defendant Vernon Hugh Bowman, a farmer, purchased the transgenic soybean seeds from the local seller who had entered into a licence for the use of those transgenic soybeans with their patent holder – Monsanto Co. The licence had imposed restrictions on any third-party buyer including Mr. Bowman from using

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[596] [1974] AC 821 (PC) 832

[597] *Iesini v. Westrip Holdings Ltd* [2009] EWHC (Ch) 80 (also as cited in Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP Oxford 2012) 615-616)

[598] Mary O'Sullivan, 'The Innovative Enterprise and Corporate Governance' (2000) Camb J Econ, 393, 393; and *Organisation for Economic Co-operation and Development, Oslo Manual,* (1st edn Eurostat, European Commission 2005) 16

[599] Andrew Pollack, 'As patent Ends, a Seed's Use Will Survive' *The New York Times* (2009)

the seeds for more than a single season or from saving the seeds replicated from the crops produced by the original seeds purchased.

After purchasing the transgenic soybean seeds the Defendant informed Monsanto that he had replanted the seeds produced from the crop harvested from the year before. Monsanto sued the Defendant for breach of the terms of the licence to use the transgenic soybeans. Monsanto argued that the Defendant had produced a new product by way of using the second regeneration seeds for planting without first obtaining the essential second license and thus was liable for infringement of the patent.

Both the lower court and the Supreme Court reached unanimous decisions in favour of Monsanto with the conclusion that the replication of the seeds from the previous crops constituted an infringement of patent. Thus, held the Defendant liable

The patent of the transgenic soybeans was due to expire in 2014 and Monsanto said that on expiry of the patent, the company would allow farmers to use the soybeans without a licence. However, the company had confidence that the farmers would move on to use the new type of soybean seeds as the beans' DNA had been upgraded to produce higher yields together with addition of other desirable characteristics.[600]

[600] Andrew Pollack, 'As patent Ends, a Seed's Use Will Survive' *The New York Times* (2009)

Comment: Similar to cases mentioned above, this case demonstrates the economic benefit, i.e., the preservation of the company's business competitiveness through business creativity secured by intellectual property right. Monsanto had the power to monopolise the soybeans market because of the directors' business decision for product innovation, i.e., the investment to develop the transgenic soybeans. This case further demonstrates that an innovative company was able to prevent the company's competitors' imitation of the products through business creativity that qualifies for patent registration; and the company's ability to control the use of the product from its buyers by way of a licence to use.

When the product reached the end of its life-circle, i.e., upon the expiry of the patent in 2014, the company would be very likely to continue its monopoly of the market through its continuing creativity. The result – the upgraded soybean seeds.

CASE STUDY NO. 5: *SHLENSKY V WRIGLEY* 237 M.E. 2D 776 [III. APP. 1968]

Facts: Between 1961-1965 the director of a baseball club known as Chicago Cubs consistently refused to install field lights which prevented the night baseball games to be played at Wrigley Field. Wrigley Field was a place where the company owned many properties in the area.

The plaintiff shareholder of Chicago Cubs was not happy with the director's business decision, brought a derivative action against the director for violating his duty of care.[601]

Comment: This case demonstrates the economic benefits, namely, the preservation of the company's business competitiveness through business creativity; cost-saving; and promotion or maintenance of the values of the company's assets, i.e., effective management of property portfolio.

In this case, the court recognized the benefits of this business innovation that emphasized long-term gain over short-termism. The benefits are shown as follows:

- preservation of the company's reputation: due to the peculiar location of the baseball field, i.e., the baseball field was at a highly populated residential area with the neighbourhood being extremely vulnerable to loud noises and disturbances. It would, therefore, be in the best interest of the company's reputation to avoid having night baseball games.

- avoid unnecessary cost (part of the company's cost cutting policy). The neighbourhood's objection to the local government's planning permission for the proposed night baseball games would anyway prevent the night games project from going ahead. The chance of success on the local residents' objection could be further

[601] Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57, Vand L Rev 83, 101

enhanced on the ground that their properties values would be adversely affected by the introduction of night baseball games. Had the planning permission being rejected, the company would have suffered a financial loss in the preparation, equipment and advertising costs for the night games; and

- the value of the company's own real estates including the baseball field at Wrigley Field could also be substantially and adversely affected as a result of the proposed night baseball games.

The court acknowledged that all the benefits mentioned above were speculative, however (similar to the UK courts' approach in *Howard Smith Ltd Ltd v. Ampol Petroleum Ltd*[602]; and *Lesini v. Westrip Holdings Ltd*[603]*)* this did not prevent the court from ruling in favour of the defendant director by way of deference through the business judgment rule. This ruling was made on the basis that the court had no jurisdiction or capability to judge the right or wrong in the quality of the director's bona fide Non-Programmed (Creative) Business Decision. To this, the judge cited the same point that had been raised in the case of *Dodge v. Ford Motor Co.*[604]

This case demonstrates the point suggested in the introduction part of the case studies, i.e., the benefits of innovation involved in cases with elements of breach of duty of

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[602] [1974] AC 821 (PC) 832

[603] (2009) EWHC (Ch) 80 (also as cited in Kershaw, *Company Law in Context: Text and Materials* (2th. OUP Oxford, 28 Jun. 2012) 615-616)

[604] 170 nw 668, 684 [Mich. 1919] (as cited in *Shlensky v. Wrigley* 237 M.E. 2d 776 179-181 (lll. App. 173 1968)

care tend to be speculative. In the process of making a business judgment, the court would allow a leeway for speculation as it is a part of trial and error process – an essential part of creativity and encouragement of creativity.

SUMMARY

Business creativity or innovation is problem solving. Companies need to be creative in business in order to remain competitive in this ever-increasing competitive market. This is so, as the advancement of modern technology such as internet has brought what had been originally constrained within the local markets onto the international stage; with product life circle shorten as a result.

As shown by the five law case studies above, business innovation not just being used at the day to day business negotiation, but also enables companies to compete with each other on equal terms by overcoming the barrier of patent rights; or to achieve market monopoly.

MOTIVATION AND ITS INTER-RELATIONSHIP WITH CREATIVITY

In the earlier part of this chapter, I established the suitable definition on which the company law deference, including UK judicial or legislated deference under the Companies Act 2006 can be assessed, from a psychology perspective. The assessment is linked to the issue on whether or not the law motivates business creativity

This section is written with an aim to seek to answer the question on whether or not the law actually motivates or works to facilitate motivating creativity.

MOTIVATION

In this section, I will be discussing the interrelation between creativity and motivation. As discussed in the first section of this chapter, the legal proceedings only focus on the legal aspects of the pre-conditions to trigger deference, namely, Non-Programmed (Creative) Business Decision (bona fide business judgment) of directors acting as an appropriate independent organ of the company (for instance, *re City Equitable Fire Insurance Co*[605]). Therefore, there is a limitation of research in the relevant law relation to motivation and creativity.

This section will compensate such limitation by purely relying on the field of psychology with the objectives to answer the question on how company directors' creativity can be motivated, from a perspective of the existing motivation theories which have been linked to creativity.[606] It will demonstrate through psychology theories, that the current law of deference has been formulated very much in line with psychology concepts of motivation and business creativity. In other words, this section will show that the current law serves as a 'motivator' with the function of promoting 'intrinsic motivation' which leads to the promotion of business creativity.

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[605] [1925] Ch. 707 (CA) [77], [78]

[606] See Chapter Three for company directors' business creativity as a real justification for judicial deference.

Psychology studies have shown that creativity cannot be maximized without motivation.[607] This section will interrogate the types of motivators that have been primarily used to achieve creativity. Detailed analysis of the types of motivators through the existing relevant theories of intrinsic and extrinsic motivation will be undertaken with research limitations either be explained or filled up by reference to law cases.

Apart from the theories of intrinsic and extrinsic motivation, this section will also explore other theories of motivation which have (in psychology) been less commonly linked to creativity but will be used in this research as another perspective to achieve a deeper understanding of the interrelation between motivation and creativity.

Once the section establishes the interrelations between motivation and creativity, I will deal with the issue of the UK law and motivation with an aim to demonstrate that the law is in line with the psychology in the aspect of motivating directors' business creativity.

Motivation is a psychology theory adopted to explain the human behaviour. In general term, motivation is a driving force behind a person's mind and action ranging from basic needs such as satisfying physical hunger through eating and drinking, to more

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[607] R. Koestner et al, 'Setting Limits on Children's Behaviour: The Differential Effect on Controlling vs. Informational Styles on Intrinsic Motivation and Creativity' (1984) J Pers 233, 246-247; T. M. Amabile, 'Motivation and Creativity: Effect on Motivational Orientation on Creative Writers' (1985) J Pers Soc Psychol 293, 299; T. M. Amabile, 'Entrepreneur Creativity Through Motivational Synergy' (1997) J Creat Behav 31(1), 18(26) (as cited by K. Jaskyte, 'Determinants of Employee Creativity: A Survey of Lithuanian Non-Profit Organisations' (2006) VOLUNTAS Vol 17 No. 2, 133, 139)

advanced needs such as striving for monetary gain and fame; or being intrinsically enjoying certain activities such as creativity.

There are a number of academic definitions of motivation. For instance, academic writers and researchers, A. J Elliot and M. Covington defined motivation basically as a person's direction to behaviour or the factors that cause a person to repeat or terminate a behaviour.[608] And Guay et al defined motivation as 'reasons underlying behaviour'.[609]

However, the definition of motivation does not help to explain its interrelationship with creativity because it is not specifically explored due to the availability of different types of motivations, with some having different effects on innovation. Therefore, for the purpose of this research, the following contains a number of motivation theories and models that have been selectively presented. These are presented on the basis of their sophistication and relevancy to demonstrate the interrelation between **motivation** and **creativity**.

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[608] A. J Elliot and M. Covington 'Approach and Avoidance Motivation' (2001) Edu Psychol Rev 13, 73

[609] Guay, F., Chanal, J., Ratelle, C. F., Marsh, H. W., Larose, S., & Boivin, M. 'Intrinsic, Identified, and Controlled Types of Motivation for School Subjects in Young Elementary School Children' (2010) Br J Educ Psychol Vol 80(4), 711, 712

INTRINSIC MOTIVATION

'The labour of love aspect is important. The most successful scientists often are not the most talented. But they are the ones who are impelled by curiosity. They've got to know what the answer is.' – Arthur Schawlow (Winner of the Nobel Prize in Physics).[610]

The above quote signifies intrinsic motivation as an essential element that motivates or encourages a person's creativity. Indeed, intrinsic motivation has been postulated as the essential element of creativity by many academic researchers such as Amabile [611]; Deci and Ryan;[612] Oldham and Cummings;[613] and Gagne & Deci.[614]

Intrinsic motivation has a number of definitions; all pointing to the same direction despite the using of different expressions. Notable definitions of intrinsic motivation include the following:

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[610] Arthur Schawlow, 'Going For Gap' Interview in The Stanford Magazine (Fall 1982, 42) (as cited by Teresa M. Amabile, 'Motivating Creativity in Organizations: On Doing What You Love and Loving What You do' [1997] Calif Manag Rev Vol 40 No. 1, 39, 39)

[611] Teresa M. Amabile, *The Social Psychology of Creativity* (1st edn, Springer-Velag, New York 1983) and 'Motivational Synergy: Toward New Conceptualizations of Intrinsic and Extrinsic Motivation in the Workplace' [1994] HRMR, 3, 183-201

[612] E.L. Deci and R.M. Ryan, *Intrinsic Motivation and Self-determination in Human Behavior (1st edn, Plenum, New York 1985)*

[613] Oldham and Cummings, 'Employee Creativity: Personal and Contextual Factors at Work.' (1996) Acad Manag J, 39(3), 507

[614] M. Gagne & E. L. Deci, 'Self-determination Theory and Work Motivation' (2005) J Organ Behav 26, 331

- ‘Self-desire to seek out new things and new challenges, to analyze one’s capacity, to observe and to gain knowledge’;[615]

- ‘Driven by deep interest and involvement in work, by curiosity, enjoyment, or personal sense of challenge.’;[616]

- ‘The doing of an activity for its inherent satisfactions rather than some separable consequences.’; [617]

- ‘Intrinsic Motivation involves people doing an activity because they find it interesting and derive spontaneous satisfaction from the activity itself.’;[618] or

- ‘… a tendency to engage in activities for their own sake, just for the pleasure of derived in performing them, so far the satisfaction of curiosity … those rewards can include feelings of wonder, even awe; pride in job well done; and the pleasure of learning something new.’[619]

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[615] R. M. Ryan and E. L Deci, ‘Self-Determination Theory and the Facilitation of Intrinsic Motivation, Social Development, and Well-Being’ (2000) Am. Psychol. 55(1): 68

[616] Teresa M. Amabile ‘Motivating Creativity in Organisations: On Doing What You Love and Loving What You Do’ (1997) Calif. Manag. Rev. Vol 40. No. 1, 39, 44; See also R. M. Ryan and E. L. Deci, ‘Intrinsic and Extrinsic Motivations: Classic Definitions and New Directions’ (2000) Contemp Educ Psychol 25. 54-67, 66

[617] R. M. and Deci, E. L, ‘Intrinsic and Extrinsic Motivations: Classic Definitions and New Directions’ (2000) Contemp Educ Psychol 25. 54-67, 66

[618] Porter and Lawler, *Managerial Attitudes and Performance* (Richard D. Irwin, Inc. (1968)) (as cited by Gagne and Deci, ‘Self-determination Theory and Work Motivation’ [2005] J Organ Behav 26, 331, 331)

[619] M.V Covington and K.J Muller, ‘Intrinsic Versus Extrinsic Motivation: An Approach/Avoidance Reformulation’ [2001] Educ Psychol Rev Vol 13, No.2, 157-176, 163

Over the years, intrinsic motivation is widely known and accepted by academic researchers as playing an essential part in creativity. For instance, Amabile has concluded through her research that **'maintaining creativity depends on maintaining intrinsic motivation'**.[620] Unfortunately, unlike other part of this research (for instance, the significance of business creativity to a company) where law cases can be used to demonstrate the subject matter; it is not possible to use law cases to examine the mindset relating to company directors' intrinsic motivation. This is so, as currently law cases within the context of directors' business decisions, judges do not explicitly seek to identify creativity and motivation as the key element and co-element respectively to justify deference.[621] Therefore, they do not "consciously" look into directors 'intrinsic motivation and its positive impact on directors' creative business decisions. I attempt to overcome this research limitation by using non-law, real case examples of entrepreneurs as follows:

Example 1: Sir Richard Branson, a successful entrepreneur revealed to The Guardian Newspaper in his 2012 interview that when he first started his own business, i.e., the publications of the student magazines, it was only a small business venture due to lack of business capital. And with the his passions to the magazine business, he was intrinsically motivated to come out with an innovative idea of providing young people

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[620] Teresa M. Amabile, 'Entrepreneur Creativity Through Motivational Synergy' (1997) J. Creat Behav 31(1), 18(26) (as cited by K. Jaskyte, 'Detreminants of Employee Creativity: A Survey of Lithuanian Non-Profit Organizations' (2006) Vol 17 No. 2, 133, 139)

[621] See Chapter Three on the misidentification of justification of judicial deference; company directors' business creativity as the real justification of judicial deference.

with a voice to key issues such as the Vietnam war. This business creativity enabled him to have a unique selling point[622] to continue the publications of the magazines. Eventually, this business idea became very popular. This popularity enabled him to raise funds through selling advertisements in each issue of the magazines and achieved the business growth.

Richard Branson concluded that, '… running a business will be a tough experience, involving long hours and many hard decisions – it helps to have that passion[623] to keep you going.'[624]

Example 2: Sir James Dyson, the founder and director of Dyson Ltd also admitted In ABC NEWS 24, that his business creativity in the Dual Cyclone bag-less vacuum cleaner was motivated intrinsically of which he also believes to be the same motivator in any engineering business.

> I love boring prosaic products making them better and making them more interesting. I like starting with products that other people ignored. You know … vacuum cleaners look like bag of soap; they look like no one ever loves them. But you know, pick up a windsurfer or ski, you can see the person who developed that was passionate about it. And I have absolute passion about rather

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[622] For Unique Selling Point as an advantage of business innovation, please see the above section relating to significance of business innovation.

[623] I.e., intrinsic motivation for the purpose of this thesis

[624] As quoted by Alex Bath, 'You Need Passion and Energy to Create a Truly successful Business' The *Guardian* (London 25th June 2012)

> boring things ... I do it because I am passionate, not because I do it for money.[625]

In answering the question as to why his company remained private, Dyson answered that he is passionate in his own creativity and that 'the last thing I wanted to do was to sell out to somebody who tells me what to do …'.[626] This statement indicates to me that the negative effect of **controlling extrinsic motivator**[627], i.e., a third party's imposition of control with the threat of punishment, such as legal intervention on director's business judgment in the absence of company law's deference.

This real-life example is being supported by research results of the economics and psychology researchers. Such as Knight who believed that directors are motivated by the 'desire to excel, to win a game'[628]; Tierney, Farmer and Graen who found that company employees who were intrinsically motivated were able to produce 'high

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[625] James Dyson on Art of Invention (ABC New 24)

[626] James Dyson on Art of Invention (ABC New 24)

[627] A form of de-motivator in psychology which yields negative effect on one's creativity; this will be discussed in full details in the following section.

[628] F Knight, *Uncertainty, and Profit* (Boston: Houghton Mifflin 1921) as cited by Keay and Loughrey, 'The Concept of Business Judgment' Legal Studies 1 < https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019 N.B. Keay et al mentioned in the article that there is a conflict of understanding between Knight's view on directors' motivation and the agency theorists. They argued that the empirical question of the two conflicting arguments remains unanswered, the law (notably section 172 Companies Act 2006) that required directors to act in the interest of the company would keep the directors at bay. On this, Chapter Five of this thesis will discuss the counter-strategies, as proposed by Kraakman et al, against agency costs with an attempt to demonstrate the balance between the tween conflicting thoughts, namely directors' motivation to succeed for the companies; and the agency cost theory.

creative outputs';[629] and the similar earlier empirical studies of Amabile which revealed that intrinsic motivation plays an indispensable role in initiating and sustaining companies' employees, including senior management, involving in tasks of creativity.[630]

In Amabile's experiment, a number of groups of test subjects were chosen with one group 'the controlled group' comprised with creative writers. The second group being writers who are being given with a set of questions that associate with intrinsic motivation, i.e., all the items that deal with intrinsic aspect of creativity, for instance, questions such as you enjoy becoming involved with ideas, characters, events, and images in your writing; and you feel relax when writing; and the final test group was given with questionnaires that deal solely with extrinsic reasons for creativity (with element of punishment for failure). For instance, you know that writing ability is one of the major criteria for acceptance into graduate school; and you have heard of cases where one of bestselling novel or collection of poems has made the author financially secure.

After the test subjects completed the questionnaires by ranking the order of importance of each question, they were asked to write a short poem with the first and

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[629] Tierney, Farmer and Graen 'An Examination of Leadership and Employee Creativity: The Revelation of Traits and Relationships' (1999) Pers Psychol 52(3). 591 as cited by K. Jaskyte, 'Determinants of Employee Creativity: A Survey of Luthuanian Non-Profit Organizations' (2006) Vol 17 No. 2, 133, 134

[630] Teresa M. Amabile 'A Model of Creativity and Innovation in organizations' (1988) Res Organ Behav, Vol 10. 123 (as cited by K. Jaskyte, 'Detreminants of Employee Creativity: A Survey of Lithuanian Non-Profit Organizations' (2006) Vol 17 No 2, 133, 134)

last line consist of the word, 'laughter'. N.B. the members of the controlled group were simply requested to write the poem without first completing the questionnaire. The result of the experiment proved intrinsic motivation enhanced creativity but when extrinsic motivation with negative consequence (i.e., if the predefined rules had not been followed) was introduced, intrinsic motivation reduced:

> After the study was complete, we asked several poets to judge these poems, using a procedure established in earlier research (cf. Amabile, 1982n, 1983a). The results were quite dramatic. As might be expected, the writers in the control group wrote poems that were judged fairly high on creativity; these were, after all, creative writers. The writers in the intrinsic group wrote poems that were judged as somewhat higher in creativity than those in the control group, but the difference was not large. The most important result comes from the extrinsic group. Those writers produced poems that were judged much lower in creativity than the poems produced by either of the other groups.[631]

Amabile further commented:

> Consider the implications of this study for 'real world' work environments. These writers entered the laboratory with an intrinsic motivational orientation toward writing. Apparently, we were not able to increase that intrinsic

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[631] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organizations' [1988] Res Organ Behav, Vol 10, 123, 139

> orientation much; the creativity of the intrinsic group isn't notably higher than the creativity of the control group. On the other hand, with a terribly brief and simple manipulation, we significantly reduced the creativity of the writers in the extrinsic group. People who had been writing creatively for years, who had long standing interests in creative writing, suddenly found their creativity blocked after spending barely five minutes thinking about the extrinsic reasons for doing what they do. If such a brief and subtle written manipulation would have such a significant impact on the creativity of highly motivated individuals, consider the potential effects of people who find themselves in those environments every day.[632]

Similar to the interrelationship of intrinsic motivation and creativity as shown in Richard Branson's and Dyson's cases discussed above, Amabile has further described the significance of intrinsic motivation to creativity by quoting the example of Robert Carr, a primary inventor of the first pen computer who responded to an offer of business opportunity from Jerry Kaplan with excitement:

> Jerry, it is not a question of whether I want to do this. I have to do this. This is important. This is profound … It is not very often that opportunities like this

[632] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organizations' [1988] Res Organ Behav, Vol 10, 123, 139

came along – something really big, a chance to really make a difference. Maybe once a decade or so, I think you have got one here. [633]

With the ground rules now being set on the issue of intrinsic motivation positively influencing creativity; now let us quickly re-visit the question raised in Chapter Three, on why company directors should be regarded as being more business creative than judges, even though both parties might possess the same level of business expertise. In other words, judges (irrespective the levels of their business knowledge) do not possess the same level of intrinsic motivation/business drive to achieve the business success of the company. Thus, are psychologically exposed to a greater degree of bounded rationality in assessing business creativity. Consequently, as concluded in many cases, Judges have admitted of being ill-equipped to assess Non-Programmed (Creative) Business Decisions (as shown in *Overend Gurney & Co v. Gibb*[634]*;* and *Lesini v. Westrip Holdings Ltd*[635]; and *Kamin v. AM. Express Co*[636]).

This leads to Chapter Three conclusion that the justification for judicial deference lies on creativity of directors' business decisions and not on the traditional understanding of the factor by questioning the business expertise of judges.

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[633] As cited by Teresa M. Amabile, 'Motivating Creativity in Organisations: On Doing What You Love and Loving What You Do' [1997] Calif Manag Rev, Vol 40. 39, 39-38

[634] [1872] LR 5 (HL) 480, 495

[635] [2009) BCC 420 (Ch) [85]

[636] 383 N.Y.S.2d, 810-11 [1976] (as cited in Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 98, 120); Stephen M. Bainbridge, *The New Corporate Governance in Theory and Practice* (1st edn, Oxford University Press, 1987) Chap 3, 111

From a psychology perspective, this lack of intrinsic motivation constitutes the 'block' of judges' business creativity for the company. Thus, judges are more inclined than company directors to succumb to bounded rationality ('the inherent limits on the ability of decision makers to gather and process information'[637]) caused by the judicial constrains and the greater limitation on access of information at any one time.[638] In other words, Judges' interest and cognitive style are not constructed for the achievement of business innovation for the company through their judicial decisions. Rather, without judicial or legislated deference regime in place, judges will be merely acting to decide judicially on the quality or the outcome of a business decision within the limited time and resources.

The existing resources and structural framework imposed by the judicial system on the judges, as being universally put by Daley, 'develop the habit of searching for the correctness instead of potential.'[639] Indeed, as mentioned by Woodman et al that researchers have established that an individual's creativity depends on the match between his or her cognitive style and his or her training or problem solving

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[637] Paul Milgrom & John Roberts, *Economics, Organization and Management* (1st edn, Pearson 1992) 127, 127-129 (as cited by Stephen M. Bainbridge, 'The Business Judgment as an Abstention Doctrine' (2004) 57 Vand L Rev 83, 118)

[638] Henry Mintzberg, Mintzberg, *Henry Mintzberg, Mintzberg on Management: Inside Our Strange World of Organizations* (1st edn, The Free Press, New York 1989) 67

[639] Kristin E. Daley, 'Taking Care of Your Creativity' (2005) The Journal of Museum Education, Vol 30, No.1 Encouraging Creativity, 23, 25, 29

objective.[640] Woodman et al drew an example by making a comparison between Research and Development (R&D) personnel and engineering instructors:

> Kirton and Pender demonstrated that Research and Development personnel were more innovative than engineering instructors and apprentices. Kirton and Pender explained that engineering instructors and apprentices are bound by a narrower range of paradigms, more rigid training, and more closely structured environment than R&D personnel.[641]

This theory coincides with the concept of bounded rationality as both apply to the situations where under the limitation of the existing organisational structure, and for the purpose of this research, the judicial system in which the judge who is bound by the limitation of resources and judicial paradigms, such as judicial precedents. As Kirton puts it:

> … when confronted with the problem, he[642] does not see it as a stimulus to query or change the structure of the problem, but seeks the solution within the structure, in ways already tried and understood, ways which are safe, sure and predictable. He can be relied upon to carry out a thorough, disciplined search

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[640] Woodman et al, 'Toward A Theory of Organizational Creativity' (1993) The Acad Manag Rev, Vol 18, No 2, 293, 305

[641] Kirton and Pender, 'The Adaption-Innovation Continuum. Occupational Type, and Course Selection' (1982) Psychol Rep Vol 51, 883 (as cited by Woodman et al, 'Toward A Theory of Organizational Creativity' (1993) Acad Manag Rev, Vol 18, No. 2, 293, 305)

[642] 'he' refers to judges for the purpose of this thesis.

> for ways to eliminate problems by 'doing things better' with a minimum of risk and a maximum of continuity and stability.[643]

And as Amabile has said that:

> … but it is clear from the empirical research (e.g., Findlay & Lumsden, in press; Simon, 1983) that the important distinction is not the *amount* of knowledge, but the way in which that knowledge is stored and the ease in which it can be accessed. If information is stored according to rigid algorithms …. Creativity is less probable. [644]

In other words, the findings by Findlay & Lumsden demonstrate that the rigid algorithms within the judicial system refer to the fact that, no matter how much entrepreneurial knowledge a business expert judge possesses, he is ill-equipped to deal with creative and innovative business decisions of company directors, as 'it is not possible to 'have too much knowledge'; it is possible to have too many algorithms'.[645]

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[643] M.K. Kirton, 'Adaptors and Innovators in Culture Clash' (1978) Curr Anthropol Vol 19 No. 3, 611, 612

[644] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisations' (1988) Res Organ Behav, Vol 10, 140, 123-167

[645] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisations' (1988) Res Organ Behav, Vol 10, 140, 123 - 167

The idea that people in different occupations are led to different cognitive styles was also re-affirmed by other writers such as Hayward and Everett.[646]

The above psychology analysis supports the notion of judicial or legislated deference on the grounds that judicial system is not equipped to interfere with company director's business creativity[647]; and the law promotes motivation of director's business creativity through judges' diffidence to interfere with directors' Non-Programmed (Creative) Business Decision.

EXTRINSIC MOTIVATION

Extrinsic motivation is another type of motivation which is often being used as an opposite factor of motivation to compare with intrinsic motivation. Gagne and Deci have made a comparison between intrinsic motivation and extrinsic motivation as:

> Intrinsic motivations involve people doing an activity because they find it interesting and derive spontaneous satisfaction from the activity itself. Extrinsic motivations, in contrast, requires an instrumentality between the activity and some separable consequences such as tangible or verbal rewards, so satisfaction

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[646] Hayward and Everett, 'Adaptors and Innovators: Data From Kirton Adaptor Inventory in a Local Authority Setting' J Occup Organ Psychol 56 339-342 (as cited by Woodman et al, 'Toward A Theory of Organizational Creativity' (1993) Acad Manag Rev, Vol 18, No 2, 293, 305)

[647] For instance, *Howard Smith Ltd v. Ampol Petroleum Ltd* (1974) UKPC 3; *Lesini v. Westrip Holdings Ltd* (2009) *BCC 420 [85]* decided under section 263(2)(a) of the Companies Act 2006; and *Kleanthous v. Paphitis* [2011] EWHC 2287 [71], [72] comment on diffidence made under section 263(3)(b) of the Companies Act 2006.

comes not from the activity itself but rather from the extrinsic consequences to which activity leads.[648]

Originally, Extrinsic motivation was only referring to external rewards that associate with an autonomous act carried out by an individual. For instance, monetary rewards given in exchange of an individual's work.[649] However, researchers soon realised the insufficiency of definition by limiting the scope of extrinsic motivation in rewards. As external or extrinsic motivator can in many circumstances include forms of threat, control or punishment. Consequently, extrinsic motivation has been sub-divided into two different sub-types. This division ensures the revised definition covers all possible areas of extrinsic motivation. Amabile has contributed into this area vastly with the following sub-types. Namely: enabling extrinsic motivation and controlling extrinsic motivation. In the following section, I will discuss each of the sub-types of extrinsic motivators in both general; and specific context to company directors in business decision making and creativity.

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[648] M. Gagne and E.L. Deci, 'Self-determination Theory and Work Motivation' (2005) J Occup Organ Psychol, Vol 26 No 4, 331, 331

[649] See for example, M. Gagne and E.L. Deci., 'Self-determination Theory and Work Motivation' (2005) J Occup Organ Psychol, Vol 26 No 4, 331

Enabling Extrinsic Motivation/Motivator: where motivation is driven by '… the desire to attain some goal that is apart from the work itself …'.[650] For instance, the desire to obtain a promised reward or meet a deadline or win a competition.[651]

The general consensus amongst psychology researchers is that 'we are more creative when we are internally motivated then when we are externally motivated.'[652]; and that 'as extrinsic motivation increases, intrinsic motivation must necessarily decline...'.[653] However, researchers have understood that, in reality, it is not possible to exclude one from another. For instance, a company director is intrinsically creative but at the same time, receiving monetary rewards from the company for his creative business decisions. Indeed, as argued by Covington and Muller that 'clearly, it is a mistake to define intrinsic motivation as absence of expectations for extrinsic payoff.'[654] As a result of the seemingly inseparable two motivators, researchers have worked to understand that 'under certain conditions intrinsic and extrinsic motivation have been found to combine in complementary fashion'.[655] This complimentary fashion refers to the extrinsic motivator that enables intrinsic motivation as argued by Deci & Ryan

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[650] Teresa M. Amabile 'Motivating Creativity in Organisations: On Doing What You Love and Loving What You Do' California Management Review Vol 40 No 1 (1997) 39-38, 44

[651] Teresa M. Amabile 'Motivating Creativity in Organisations: On Doing What You Love and Loving What You Do' (1997) Calif Manag Rev Vol 40 No 1, 44, 39-38

[652] Donald Woods, 'Creativity' (1989) JCST, Vol 18, No. 4, 259, 259; and see generally, T. M. Amabile, 'How to Kill Creativity' (1998) HBR, 77-87

[653] M. Gagne and E.L. Deci, 'Self-Determination Theory and the Social Psychology of Creativity' (2000) PI, Vol 11, No 4, 293, 295

[654] M.V. Covington and K.J. Muller, 'Intrinsic Versus Extrinsic Motivation: An Approach/Avoidance Reformulation' (2001) Edu Psychol Rev, Vol 13, No 2, 157, 162

[655] M. Gagne and E.L. Deci, 'Self-Determination Theory and the Social Psychology of Creativity' (2000) PI, Vol 11, No 4, 293, 295

that extrinsic motivator 'supports a sense of competence without undermining self-determination should positively contributes to intrinsic motivation'[656]. In other words, '… when individuals believe they can obtain rewards by being creative, they become more creative.'[657]

From company directors' point of view, enabling extrinsic motivators refer to:

- Rewards, such as status, financial rewards, fame and recognition achieved through the implementation of their business decisions as directors. In other words, in the context of directors' business decisions, Enabling Extrinsic Motivator occurs naturally once creativity is achieved through Intrinsic Motivator and then in turn, Enabling Extrinsic Motivator will arguably enhance or encourage the director's Intrinsic Motivator.[658] I coin this process with the term – The spiral of Motivator. The word, 'Spiral' is used due to the endless expansion of the process; and/or

- As the definition suggests, enabling extrinsic motivator can take the form of directors' creative business decision justifying the company's prior approval of allocating additional resources to sufficiently enable the director to undertake the research of the creative project; and eventually lead to the execution of the innovative business decision. The former motivators act as enhancers of the directors' original

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[656] E.L. Deci & R. M. Ryan, *Intrinsic Motivation and Self-determination in Human Behaviour* (1st edn, Springer Science & Business Media, New York 1985) (as cited by Hennesy, 'Self-Determination Theory and the Social Psychology of Creativity' (2000) PI, Vol 11, No 4, 293, 295)

[657] Linda Shanock et al, 'Rewards, Intrinsic Motivation, and Creativity: A Case Study of conceptual and Methodological Isolation' (2003) Creat Res J Vol 15, Nov 2 & 3, 121, 128

[658] ibid

desire or intrinsic motivation to be creative and innovative. The latter motivator increases the directors' confidence to implement the business decision, thus, making the directors significantly less **boundedly rational** both psychologically and financially than judges in judging a business decision.

From judges' perspective (irrespective of the degree of their business expertise), when dealing with lawsuit cases, they can be motivated by **limited** extrinsic motivator, i.e., reduction of caseload by concluding the present case. This serves as an extrinsic reward that often can be obtained by judges within their judicial power. Therefore, Canard's argument of different types of care applies.[659] In other words, these extrinsic motivators subject the judges to a great degree of bounded rationality, and thus rendering them ill-equipped to interfere with directors' Non-Programmed (Creative) Business Decisions. This is so, because the extrinsic motivator is based on cutting down the caseload, rather than the actual interest of the company. Similar to the above analysis on intrinsic motivation, this psychology analysis on the law from the perspective of enabling extrinsic motivation, once again, supports the notion of judicial deference on the grounds that judicial system is not equipped to interfere with director's business creativity[660]; and the law motivates director's business creativity

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[659] Alfred. F. Conard, 'A Behavioral Analysis of directors' Liability for Negligence' (1972) Duke L J, 904

[660] For instance, *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] UKPC 3; and *Lesini v. Westrip Holdings Ltd* [2009] BCC 420 [85] decided under section 263(2)(a) of the Companies Act 2006; and *Kleanthous v. Paphitis* [2011] EWHC 2287 [71], [72] comment on diffidence made under section 263(3)(b) of the Companies Act 2006.

through judges' diffidence to interfere with directors' Non-Programmed (Creative) Business Decision.

ENABLING EXTRINSIC MOTIVATION DILUTING INTRINSIC MOTIVATION

It is worth of mentioning here that in certain situation, enabling motivator can decrease one's intrinsic motivation. This has been shown in Deci's experiment on two groups of students who were at the initial stage of the experiment, intrinsically motivated at the experimental activities. One group of students was offered with extrinsic rewards and the other group without. When both groups were offered to participate the second-round experimental activities, the group that was initially offered with extrinsic reward showed a 'withdrawal symptom', i.e., a significant decrease of intrinsic motivation in the activity as opposed to the other group. This experiment has provided a useful understanding on the negative effects of extrinsic environmental constraints on people's intrinsic motivation. Dermer said:

> Deci explains his finding by reasoning that when a person is intrinsically motivated, he perceives the locus of causality of his behaviour to be within himself, i.e., he is motivated solely by the internal satisfaction the task provides. But when the performance-contingent extrinsic rewards are imposed, the perceived locus of causality of his behaviour shifts to his environment, he

> perceives himself now working for money, and his intrinsic motivation declines.[661]

The question now is whether or not company director's creativity can be detrimentally affected or diluted by the 'extrinsic monetary rewards[662]'? I do not think so. This is because, with Deci's experiment, the test subjects had prior knowledge that the accomplishment of the task would yield the extrinsic monetary rewards.[663] This is clearly different to company directors engaging in creative business decision-making, as with company directors, the outcome that could be generated by the creative business idea is unknown or uncertain as shown in the case of *Dodge v. Ford Motor Co.*[664] Therefore, such a reward comes not by choice. This can be backed up by two independent research results namely, Amabile's finding in 1983, that:

> A person's extrinsic rewards interacts with his or her choice. Monetary reward given for performance on a task for which the individual has no choice can

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[661] As cited by Jerry Dermer, 'The Interrelationship on Intrinsic and Extrinsic Motivation' (1975) Acad Manag J vol 18, No 1, 125, 127

[662] Director extrinsic reward/remuneration 'is defined as payment or compensation received for services or employment and includes base salary, any bonuses and any other economic benefits that an employee or executive receives during employment'. This directorial remuneration is provided to ensure that directors are doing a good job for the company. Kaplan Financial Knowledge Bank (2012) < http://kfknowledgebank.kaplan.co.uk/KFKB/Wiki%20Pages/Directors%27%20remuneration.aspx> accessed 25 November 2017

[663] This is arguably different to company directors' remunerations as such payment is contractually made on regular basis and the decision of whether or not to pay the remunerations to directors are made by the directors themselves. Therefore, there is no 'withdrawal symptoms' as described in Deci's experiment above. In fact, according to Maslow's Hierarchy of needs, directors' remuneration is a necessity to keep up his intrinsic motivation on creativity in order to first satisfy the lower needs, i.e., physical and safety needs before the higher needs can be triggered. P. Singh et al, 'Organisational Culture and Its Impact on managerial Remuneration' (1977) IJIR, vol 13, No 1, 1-14; Fuller & Dornbush, 'Organisational Construction of Intrinsic Motivation' (1988) Sociol Forum, Vol 3 No 1, 1-3; and Lloyd Greene and George Burke, 'Beyond Self-Actualisation' (2007) JHHSA, Vol 30, No 2, 116, 124

[664] [Mich 1919] 170 NW 668

> enhance creativity. But when individual is offered a reward for consenting to perform the task, creativity may actually be undermined.[665]

This is also supported by Deci et al:

> The Deci et al (1999) meta-analysis also confirmed CET hypotheses (Cognitive Evaluation Theory) that specified limiting conditions to the undermining effect. Namely, it showed that when rewards were given independent of specific task engagement (as might be the case with salary) or when the rewards were not anticipated (as might be the case of unexpected bonuses), tangible extrinsic reward did not undermine intrinsic motivation.[666]

Another reason (from the legal perspective) is that enabling extrinsic motivator does not dilute company directors' creativity because usually the ultimate beneficiary of the extrinsic reward would be the company and not its directors, as shown in the case *re. Walt Disney Co Derivative Litig.*[667] where directors negotiated a directorship contract with a third party for the sole benefit of the company. As mentioned in the earlier part of this chapter, that the definition of creativity entails the essential component known as 'usefulness' which refers to the existence or possible existence of extrinsic rewards for the company. In other words, under the component of 'usefulness', the director has to make the business decision with an intention to

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[665] Woodman et al, 'Toward a Theory of Organizational Creativity' (1993) Acad Manag Rev, Vol 18, No 2, 293, 321

[666] Deci et al, 'Self-determination Theory and work Motivation' J Organ Behav, Vol 26, No 4, 331, 332

[667] (2005) (Disney V). 07 A. 2d 693

benefit the company. This allows situations of trial and error, as not every business decision is guaranteed to produce an outcome that actual benefits the company. Therefore, directors have to satisfy condition of 'usefulness', in order for their business decision to be classified as creative within the definition of creativity. This psychology analysis of the enabling extrinsic motivator within the definition of creativity demonstrates that the law, i.e., section 263(2)(a) of the Companies Act 2006 requiring the business decision being made by the director bona fide (linking to section 172), in the interest of the company ('interest' = extrinsic reward to the company) does not dilute director's intrinsic motivation of creativity.[668]

CONTROLLING EXTRINSIC MOTIVATION/MOTIVATOR

Controlling Extrinsic Motivator refers to restrictions on how works are to be done and possibly coupled with punishment or risk or threat (uncertainty) of punishment for failure to achieve the objective. Controlling motivator is known to be incompatible with an individual's intrinsic motivation and hence a block to creativity.[669] This is so, because it is aimed to find fault with ideas as they arise, instead of allowing ideas to flow freely. [670]

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[668] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP Oxford 28 Jun. 2012) 613; Extarsure Insurance Limited v. Scattergood [2003] 1 BCLC (Ch) [90], [97]; and *Franbar Holdings Limited v. Patel* [2009] 1 BCLC 1 (Ch) 11

[669] Teresa M. Amabile 'Motivating Creativity in Organisations: On Doing What You Love and Loving What You Do' (1997) Calif Manag Rev Vol 40, No 1, 45, 39-38; see also Joseph R. LaChapelle, 'Review on the Social Psychology of Creativity' (1985) National Art Education Association, 47

[670] Robert T. Clemen and Terence Reilly, *Making Hard Decisions with DecisionTools* (1st edn, Brooks/Cole 2004) 226

Several empirical studies have revealed that Extrinsic Controlling Motivator serves as a de-motivator to people's creativity. For instance, a study conducted by Folger, Rosenfield and Hays[671] where two groups of people with intrinsic motivation to perform a particular experimental task were chosen; with Group One being given a choice to perform the task in exchange of reward. But the reward would only be given upon the condition that the experimental task was to be completed in accordance to the given rule. In other words, the reward was offered with an element of control and punishment if the test subjects failed to complete the given task. On the other hand, Group Two was given the promise that the reward would be given irrespective whether or not the experimental task was completed. In other words, no element of controlling extrinsic motivator was present. The result showed that Group One (with choice being given on the reward and punishment) was psychologically restricted by and diverted its focus on the controlling extrinsic reward/punishment, thereby performing significantly less creative than Group Two where no choice was given on reward/punishment.

Another similar experiment was conducted by Amabile, Henessey and Grossman[672] which yielded with the same result. 'Thus, this study demonstrated that it is not

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[671] Folger, Rosenfield and Hays, 'Equity and Intrinsic Motivation: the Role of Choice' (1978) J Person Soc Psychol 36, 557-564 (as cited by Hennessey, *'Social, Environmental and Developmental Issues and Creativity'* (1995) Edu Psychol Rev, Vol 7, No 2, Toward an Educational Psychology of Creativity, Part I, 163, 167)

[672] T. Amabile and J. Gitomer, 'Children's Artistic Creativity: Effects of Choice in Task Materials' (1986) Unpublished manuscript, Brandeis University (as cited by Hennessey, 'Social, Environmental and Developmental Issues and Creativity' (1995) Edu Psychol Rev, Vol 7, No 2, Toward an Educational Psychology of Creativity, Part I, 163, 167)

reward per se but rather the functional significance of reward as controlling of performance that undermines creativity.'[673]

Amabile has concluded that, '… punishments associated with the outputs, thus increasing the presence of extrinsic motivation and its …negative effect on intrinsic motivation.'[674]

In addition, these psychology studies have demonstrated the difference between the legal restriction and the market regulation. In that, as opposed to legal restriction by way of duty of care regime (in the absence of judicial or legislated deference), directors' intrinsic motivation is less likely to be affected adversely by market regulation. This is because with market regulation, the element of punishment comes with less or no choice. In other words, directors can be derivatively sued for their negligence within the process of business creativity, but they will not be sued for adopting a more conservative business approach without taking business risk arisen from creativity. However, directors can be removed from the board for either causing financial loss to the company as a result of their business negligence; or they can be removed from the board for not making the company commercially competitive as a result of lacking innovation.

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[673] Hennessey, 'Social, Environmental and Developmental Issues and Creativity' (1995) Edu Psychol Rev, Vol 7, No 2 Toward an Educational Psychology of Creativity, Part I, 163, 167)

[674] Teresa M. Amabile, 'How to kill Creativity' (1998) HBR, 76 No 5, 76, 76 -78

Empirical studies have also been conducted by Amabile and Gitomer on the effect of controlling extrinsic motivator on creativity from another perspective. This time, the element of choice was associated with the freedom of carrying the task, rather than associated with the given or withdrawal of reward as a form of punishment. In other words, the controlling element was related to the "no choice condition" whereby the no choice condition group was asked to implement a specific task only. The result shows that the test subjects with the given choice of freedom of expression significantly out-performed in creativity over the test subjects in no choice condition. This result was clearly in line with Maitland's position (as mentioned in the sub-section of Definition of Creativity) that 'creativity is a form of human freedom'[675] Certainly, in the context of corporate management activities, there has been a rise of so called the "Active Investors" where attempts have been exercised to vigorously influence the corporate board's business decisions through external means such as threat of litigations and public relations campaign etc.[676] As this research is primarily focused on the legal or judicial influence on directors' creativity; the exact extent to which other non-legal or non-judicial external means to influence directors' business decisions will be the subject of another research. This had also been agreed by Deci and Ryan that:

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[675] J. Maitland, 'Creativity' (1976) J Aesthet Art Crit, Vol 34, No 4, 397, 408; see also Kristina Jaskyte and Audrone Kisieline, 'Determinants of Employee Creativity - A Survey of Luthuanian Non-Profit Organisations' (2006) Voluntas, Vol 17, No 2, 133, 139

[676] Tom C.W. Lin 'Reasonable Investor(s)' (2015) B U L Rev, 472, 472-473; and Maria Welker et al, 'Shareholder Activism and Alienation' (2011) Curr Anthropol, Vol 52, No, S3, 62

> When autonomous, people experience themselves as initiator of their own behaviour; they select desired outcomes and choose how to achieve them. Regulation through choice is characterized by flexibility and the absence of pressure. By contrast, being controlled is characterised by greater rigidity …[677]

Once again, the results of these experiments further support the view that the legislated deference under the Companies Act 2006 effectively removes controlling motivator; and promotes intrinsic motivation on directors' business creativity.

CONTROLLING EXTRINSIC MOTIVATOR AS A POSITIVE FACTOR DOES NOT APPLY TO DIRECTORS BUSINESS JUDGMENT

This will then lead us to explore another psychology finding. Fuller & Dornbush; and Muller have argued that the negative effect of extrinsic control motivator can be removed if such a controlling system 'are explicitly and legitimately allocated, when workers **cannot choose** what tasks they will perform...'[678]; and ' when social information communicates a clear **benchmark** for judging one's own performance (rather than obtrusively controlling action), intrinsic motivation may rise'.[679] In other words, Fuller & Dornbush, and Muller have argued that extrinsic motivator does

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[677] E. L.Deci and R.M. Ryan, 'The Support of Autonomy and the Control of Behaviour' (1987) J Pers Soc Psychol 53, 1024, 1025 (as cited by Linda Shanock et al, 'Rewards, Intrinsic Motivation, and Creativity: A Case Study of conceptual and Methodological Isolation' (2003) Creat Res J Nov. 2 & 3, 121, 122)

[678] Fuller & Dornbush, 'Organisational Construction of Intrinsic Motivation' (1998) Social Forum, Vol 3 No 1, 1 – 5; See also in general, K.J. Muller, 'Intrinsic Versus Extrinsic Motivation: An Approach/Avoidance Reformulation' (2001) Edu Psychol Rev Vol 13 No 2, 157

[679] Fuller & Dornbush, 'Organisational Construction of Intrinsic Motivation' (1998) Social Forum, Vol 3 No 1, 1 – 5; See also in general, K.J. Muller, 'Intrinsic Versus Extrinsic Motivation: An Approach/Avoidance Reformulation' (2001) Edu Psychol Rev Vol 13 No 2, 157

not negate an organisational worker's intrinsic motivator if certain conditions are satisfied, namely, 1. That the individual worker has no choice in deciding whether or not to perform the work; 2. That the controlling system is well organised which would be used as a benchmark in judging or evaluating the performance of the workers; and 3. That the importance of such a benchmark to the work performed is clearly communicated to the worker.[680]

Having set out the psychology argument above, my research finding shows that this psychology principle does not apply to directors' business decision within the realm of creativity for the flowing reasons:

- As mentioned above, the principle only works when the directors in their business decision-making process have no choice in deciding the performance of the work. However, in reality, when directors are engaging in Non-Programmed (Creative) Business Decisions, they have a choice on whether or not to implement such a business decision or on how the decision is to be implemented without being restricted by any predefined rule (as defined by H.A. Simon). This is also indicated in the experiment results of Folger et al[681]; and Amabile et al[682] mentioned above.

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[680] See generally, Fuller & Dornbush, 'Organisational Construction of Intrinsic Motivation' *(2001)* Sociol Forum, Vol 3 No 1, 1, 5; K.J. Muller, 'Intrinsic Versus Extrinsic Motivation: An Approach/Avoidance Reformulation' (2001) Edu Psychol Rev, Vol 13 No 2, 157

[681] Folger, Rosenfield and Hays, 'Equity and Intrinsic Motivation: the Role of Choice' (1978) J Person Soc Psychol 36, 557-564 (as cited by Hennessey, 'Social, Environmental and Developmental Issues and Creativity' (1995) Edu Psychol Rev, Vol 7, No 2, Toward an Educational Psychology of Creativity, Part I, 163, 167)

[682] T. Amabile and J. Gitomer, 'Children's Artistic Creativity: Effects of Choice in Task Materials' (1986) Unpublished manuscript, Brandeis University (as cited by Hennessey, 'Social, Environmental and

Furthermore, the principle of 'types of due cares and diligence' put forward by Conard, arguing that when company directors are facing potential legal threats requiring directors to exercise due diligence relating to the implementation of a business decisions, directors would exhibit risk adverse tendency by exercising due diligence undesirable to the company, for instance, keeping up unnecessary paper trails and consulting professionals unnecessarily all for the purpose of safeguarding their own positions that causes extra expenses and unnecessary delay to the company, rather than in the best interest of the company; and

- The psychology principle only applies to programmed business decisions, i.e., business decision governed by a predefined rule, for instance, internal control policy that company directors are required to be attentive (*Dorchester Finance v. Stebbing*[683]) within the psychology concept of types of decisions proposed by H.A Simon. To put it simply, the psychology principle does not apply to business decisions involving creativity. As mentioned in the earlier part of this Chapter dealing with the proposed Definition of Creativity, the fundamental rule for creativity is human freedom (H.A Simon; Maitland; Dimock; and Jaskyte & Kisieline)[684]; in the context of this research, that refers to the situation where the directors' business decision is not being governed

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Developmental Issues and Creativity' (1995) Edu Psychol Rev, Vol 7, No 2, Toward an Educational Psychology of Creativity, Part I, 163, 167)

[683] [1989] BCLC 498 (Ch)

[684] See generally H.A. Simon, *The New Science of Management Decisions* (1st edn, Prentice-Hall, 1965); J. Maitland, 'Creativity' (1976) J Aesthet Art Crit, Vol 34, No 4, 397, 408; M. Dimock, 'Creativity' (1986) Public Adm Rev, Vol 46, No 1, 3, 7; and Kristina Jaskyte and Audrone Kisieline, 'Determinants of Employee Creativity: A Survey of Luthuanians Non-Profit Organisations' (2006) VOLUNTAS, Vol 17, No 2, 133, 139

by any predefined rule or benchmark. Therefore, the principle of controlling extrinsic motivator being a positive factor corroborating with intrinsic motivator only applies to a programmed business decision, i.e., business decision that is governed by predefined rules; and not a non-programmed business decision within the realm of human freedom of creativity.

It should be noted that the corresponding research of Fuller and Dornbush above was not about creativity. The research was within the objective of looking into the interrelationship between intrinsic and extrinsic motivators within organisations that leads to job satisfaction. However, Fuller and Dornbush's research remains relevant to my own research due to its relevance to the concept of programmed business decisions of which shall be fully discussed in the Chapter Five.

CONTROLLING EXTRINSIC MOTIVATOR AND UK COMPANY LAW'S DEFERENCE

In the above, I have demonstrated that Part 11 of UK Companies Act 2006 had been formulated to promote directors' intrinsic motivation with the effect of promoting directors' business creativity.

To examine the same point from the perspective of the psychology theory of controlling extrinsic motivation, the promotion of directors' business creativity is currently achieved through the Companies Act 2006 with the continuity of the common law approach of judicial diffidence on directors' power of making Non-Programmed (Creative) Business Decisions. In doing so, the law effectively

excludes the element of controlling extrinsic motivator from the directors' decision-making process. In other words, as shown in the cases such as *Iesini v. Westrip Holdings Ltd*[685] the court adopted a very similar deferential approach as shown in the earlier common law case of *Overend Gurney & Co v. Gibb*[686]; and *Stainer v Lee*[687] where the judges excluded the controlling extrinsic element by refusing to impose punishment upon the director for the outcome of their business judgments. The Judge's ruling were based on the condition that that such a business decision had been made by the director (as an appropriate independent organ of the company) in good faith, and in the interest of the company.[688] From a psychology perspective, one can summarily conclude that the law which offers freedom to directors, in their business decision-making process, is 'characterized by flexibility'[689] as opposed to 'rigidity'.[690]

LOCUS OF CONTROL & MASLOW'S HIERARCHY OF NEEDS

In the following section, I will explore a number of other motivation theories in support of my argument that company directors' business creativity requires

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[685] [2009] BCC 420 (Ch) [85] & [86]
[686] [1872] L R 5 (HL) 580
[687] [2010] EWHC 1539 (Ch) (as cited by Newey J in *Kleanthous v. Paphitis* [2011] EWHC 2287 (Ch)[40])
[688] *Stimpson v Southern Landlords Association* [2009] EWHC 1556 (Ch) [7]
[689] E. L.Deci and R.M. Ryan, 'The Support of Autonomy and the Control of Behaviour' (1987) J Pers Soc Psychol 53, 1024, 1025 (as cited by Linda Shanock et al, 'Rewards, Intrinsic Motivation, and Creativity: A Case Study of conceptual and Methodological Isolation' (2003) Creat Res J Nov. 2 & 3, 121, 122)
[690] E. L.Deci and R.M. Ryan, 'The Support of Autonomy and the Control of Behaviour' (1987) J Pers Soc Psychol 53, 1024, 1025 (as cited by Linda Shanock et al, 'Rewards, Intrinsic Motivation, and Creativity: A Case Study of conceptual and Methodological Isolation' (2003) Creat Res J Nov. 2 & 3, 121, 122)

motivation and that the current legal system that insulates directors from negligence liability motivates directors' creativity. I will further use the theory of Maslow's Hierarchy of Needs to support my argument that company directors being more business creative than judges, even though both parties can be non-business experts. This eventually links back to the previous conclusion that the justification for judicial or legislated deference lies on creativity of directors' business decisions and not on the traditional understanding on questioning the business expertise of judges. These theories have been selected for the following research because of their interrelation to intrinsic motivation that motivates business creativity.

J.S. Eccles and A. Wigfield have proposed a theory of motivation based on self-worth and locus of control. They argued that people can be more motivated when they are being put in a position that allows them to feel that they are in control of their ultimate success.[691] In other words, people need to first possess or be given a sense of self-worth or self-importance that directly relates to the task in order to be creative and successful in delivering an excellent completion of that task. This theory has been used by researchers (e.g., Seeman; Deci; and Shapira)[692] in intrinsic and extrinsic motivation to support their findings that 'tasks controlled from above hold

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[691] See generally, J.S. Eccles and A. Wigfield, 'Motivational belief, Values and Goals' (2002) Annu Rev Psychol Vol 53, 109

[692] M. Seeman, 'Alienation Studies' (1975) Annu Rev Sociol, 191; E.L. Deci, *Intrinsic Motivation* (1st edn Plenum Publishing Company Limited, 1975); and Z. Shapira, 'Expectancy Determinants of Intrinsically Motivated Behaviour' (1976) J Pers Soc Psychol, 1244 (all cited by Fuller & Dornbush, 'Organisational Construction of Intrinsic Motivation' (1998) Social Forum, Vol 3 No. 1, 1, 4)

less intrinsic value since they failed to offer the individual a feeling of challenge or efficacy (Deci, 1975; and Shapira, 1976).'[693]

This theory of motivation was further used to support the enhancement of intrinsic motivation by Woodman & Schoenfeldt in which they claimed an indispensable link between locus of control and intrinsic motivation. In particular, Woodman & Schoenfeldt claimed 'highly creative people tend to have an internal locus of control'.[694] This theory has been tested by Shalley and Oldham with result indicating otherwise. However, the reason for such conflicting results between two different experiments was simply due to different experiments involved different experiment tasks. Shalley and Oldham adopted a simple assembly task which required the test subject to strictly follow a predefined rule – a task which had no significance to creativity. Whereas the other experiments adopted a more complex - non-programmed tasks, that contained elements of freedom or creativity.[695]

The theories of self-worth and locus of control were presented in line with another important and more comprehensive psychology and management theory known as self-actualization within the hierarchy of needs proposed by Abraham Maslow in his

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[693] Fuller & Dornbush, 'Organisational Construction of Intrinsic Motivation' (1998) Social Forum, Vol 3 No. 1, 1, 4

[694] Woodman, Sawyer and Griffin, 'Towards the Theory of Organizational Creativity' (1993) Acad of Manag Rev, Vol 18, 293, 306

[695] C.E. Shalley, G.R. Oldham & J.F. Porac, 'Effect of Goal Difficulty, Goal Setting Method, and Expected External Evaluation on Intrinsic Motivation.' (1987) Acad Manag Rev, Vol 30, No 3, 553, 561

article, 'A Theory of Human Motivation' published in 1943.[696] This theory has also been used by a number of psychology researchers in support of their findings relating to intrinsic motivation (Argyris; Hackman; Oldham; and Basadur).[697] And is consistently deemed by writers such as Rakich, Longest and Darr as 'one of the most important and enduring theory of motivation'.[698]

It should be noted that Maslow's Hierarchy of Needs is chosen for this thesis despite being shrouded with some criticisms, for the reasons that it compliments with and supports the interrelationship between Intrinsic Motivator and Controlling Extrinsic Motivator theory within creativity as discussed earlier on.[699] The main focus of the needs within the hierarchy in the context of this thesis lies on Safety/Security Need. More precisely in the context of this thesis, the need to be free from the fear of lawsuit. In other words, it argues that 'that once basic substance needs are met, the individual invariably pursues these higher order psychological drives within organisations.'[700]

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[696] Abraham H. Maslow, 'A Theory of Human Motivation' (1943) Psychol Rev 50(4) 370; See also generally, Abraham H. Maslow, *Motivation and Personality* (3rd edn, Longman, 1987) Chapter 11: Self-Actualization People: A Study of Psychological Health

[697] Fuller & Dornbush, 'Organisational Construction of Intrinsic Motivation' (1993) Social Forum, Vol 3 No 1, 1, 3; See also M.S. Basadur, 'Organisational Development Interventions for Enhancing Creativity in the Workplace' (1995, 1997) J Creat Behav, 31(1), 59, 61

[698] Rakich, Longest, Darr, 'Managing Health Services Organizations' (2000) Baltimore: Health Professions Press (as cited by L. Greene and G. Burke, 'Beyond Self-Actualisation' (2007) JHHSA, Vol 30, No 2, 116, 117)

[699] L. Greene, 'Beyond Self-Actualisation' (2007) JHHSA, Vol 30, No 2, 116, 124

[700] Fuller & Dornbush, 'Organisational Construction of Intrinsic Motivation' (2007) Social Forum, Vol 3 No. 1, 1, 3; and L. Greene and G. Burke, 'Beyond Self-Actualisation' (2007) JHHSA, Vol 30, No 2, 116, 124

Furthermore, the criticisms of the hierarchy of needs do not apply to the conditions set in this thesis, because: 1. the theory of hierarchy of needs is arguably not applicable to the society based on collectivism. Collectivism refers to authoritarian states or systems such as fascism or Maoism[701] all of which do not represent the social circumstances of countries like UK and US; or 2. the argument that the role of sex has not been placed in Maslow's hierarchy[702] of which, bears no relation whatsoever to this thesis.

The summary statements linking intrinsic motivation to Maslow's Hierarchy of needs can be '…man's tendency to actualize himself, to become his potentialities … '[703] and an individual's creativity was realized, '…because it is satisfying to him, because this behaviour is felt to be self-actualizing'[704]

Under the theory of hierarchy of needs, as the name of the theory suggests, there are a number of specific needs arranged in hierarchical orders or as often been depicted, in the shape of a pyramid with the lowest level starts from 1. the basic needs which generally refer to physiological needs such as food, shelters, oxygen or other basic

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[701] R. Cianci, and P.A. Gambrel, 'Maslow's Hierarchy of Needs: Does it Apply in a Collective Culture' (2003) JAME 8(2): 143, 161

[702] D. Kenrick, 'Rebuilding Maslow's Pyramid on an Evolusionary Foundation' (Psychology Today 2010) *https://www.psychologytoday.com/blog/sex-murder-and-the-meaning-life/201005/rebuilding-maslow-s-pyramid-evolutionary-foundation> accessed 16th July 2016*; see also V. Griskevicius et al, *'Renovating the Pyramid of Needs: Contemporary Extensions Built Upon Ancient Foundations' (2010)* Perspect Psychol Sci 5, 292

[703] Carl Rogers, *On Becoming a Person: A Therapist\'s View of Psychotherapy* (1st edn, Mariner Books, 1961) 350, 350,351

[704] C. R. Rogers, 'Towards the Theory of Creativity' (1954) Rev Gene Sem 11, 249, 252 (as cited by Linda Shanock et al, 'Rewards, Intrinsic Motivation, and Creativity: A Case Study of conceptual and Methodological Isolation' (2003) Creat Res J, Vol 15, Nov, 2 & 3, 121, 122

elements for human survival, therefore, must be firstly satisfied before any other needs; 2. safety needs which refer to physical, psychological or economical safety such as safety from physical war, the protection of law or elements that relates to financial security respectively; 3. social needs which refer to an individual's inter-personal relationship with people surrounding him or needs to feel a sense of belonging and acceptance within his social circle; 4. esteem needs which refer to the needs to be respected by both the individual himself and the others or a sense of contribution towards an accomplishment of a given task; and 5. the highest and final level of needs is known as self-actualization needs which can refer to a person's feeling of realizing his potential through life-time achievements, continuous focus on personal growth, problem solving, life appreciation or peak experience of oneself.[705] This can include attaining to a particular high level of position within an organization. For instance, holding an office as a director of a large international I.T. company and continuing advancement of his directorial career. As pointed out by Maslow, the importance of self-actualization is that its essence of creativeness is a complete acceptance of oneself with the freedom of expression without the threat of being

[705] A.H. Maslow, 'A Theory of Human Motivation' (1943) Psychol Rev, Vol 50, 370; Huitt, 'Maslows Hierarchy of Needs' (2004), (as cited by JMHA Redmond, *'Need Theories'* (Confluence 2015) < https://wikispaces.psu.edu/display/PSYCH484/2.+Need+Theories> accessed 16th July 2016; see also Kristin E. Daley, *'Taking Care of your Creativity'* (2005) JME, Vol 30, No 1, Encouraging Creativity, 23, 24.

'controlled' by another.[706] This effectively demonstrates the interrelationship between intrinsic & extrinsic motivation and the Hierarchy of needs.

As self-actualization represents the most advanced need within the hierarchy, an individual could only attain to such a level after he has been first satisfied with lower level of needs, e.g., physical, security and social needs. This process is known as 'fulfillment progression'.[707] For instance, a person who has a potential to be a great artist is arguably not being able to fully realize his talent if the focus is diverted to satisfying the lower level of needs such as the needs to earn enough money to keep his life-style up to a reasonable level or the needs to be insulated from constant threat of legal actions.[708]

To put the combining theories of locus of control and Maslow's into the context of this research, it is reasonable and logical to deduce and conclude that an individual is much less likely to strive for the best interest of the company without first regarding the company's business as a platform of his own ambition through his directorship in the company. After reaching the directorial office, he is not in the position of being motivated to be self-actualised by way of being creative in his business decision making until his physical and safety needs within Maslow's hierarchy can be

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[706] A. H. Maslow, 'Creativity in Self-Actualised People', 84 (as cited by Kristin E. Daley, 'Taking Care of your Creativity' (2005) JME, Vol 30. No. 1, Encouraging Creativity, 23, 24 & 29

[707] JMHA Redmond, *'Need Theories'* (Confluence 2015) < https://wikispaces.psu.edu/display/PSYCH484/2.+Need+Theories> accessed 16th July 2016

[708] As described by L. S. Daniel et al, *Psychology: European* (1st edn, Palgrave Macmillan, New York 2011) 486-487

continuously satisfied, e.g., free from being sued for ordinary negligence relating to the quality of his creative business decisions. Maslow has specifically link safety needs to 'an immedicable necessity of a viable political, social, or economic system and that is to more creative people.'[709] As pointed out by Whittington and Evans, this process of moving around the hierarchy of needs means that the achievement of each level of needs is not perpetual and that an overlap of needs is more than likely to occur throughout a person's lifetime. Therefore, company directors need to be constantly reassured that the lowers needs are revisited to prevent the 'needs deficiency',[710] in order to maintain creativity for continuously satisfying the advance needs.

Whittington and Evans's finding that '…each of these needs operates at all times, although one deficient set dominates the individual at one time and circumstance …'[711] is also supported by O'Connor and Yballe that the hierarchy of needs is an, 'ongoing process that involves dozens of little growth choices …'.[712]

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[709] A.H Maslow, *The Further Reaches of Human Nature* (1st edn, Penguin / Arkana, 1993) 93 (as cited by L. Green and G. Burke, 'Beyond Self-Actualisation' (2007) JHHSA, Vol 30, No 2, 116, 124

[710] See generally, Whittington and Evans, 'The Enduring Impact of Great Ideas' (2005) Prob Pers Manag, 2, 114; and Abraham H. Maslow, *Motivation and Personality* (3rd edn, Longman 1987) Chapter 11: Self-Actualization People: A Study of Psychological Health (all as cited by JMHA Redmond, 'Need Theories' (Confluence 2015) <https://wikispaces.psu.edu/display/PSYCH484/2.+Need+Theories> accessed 16th July 2016)

[711] Whittington & Evans in 'The Enduring Impact of Great Idea' (2005) Prob Pers Manag 2, 114 (as cited by JMHA Redmond, *'Need Theories'* (Confluence 2015) < https://wikispaces.psu.edu/display/PSYCH484/2.+Need+Theories> accessed 16th July 2016)

[712] O'Connor and Yballe, 'A. H. Maslow Revisited: Construction a Road Map of Human Nature' (2007) J MANAG EDU, 31(6), 738 (as cited by JMHA Redmond, *'Need Theories'* (Confluence 2015) < https://wikispaces.psu.edu/display/PSYCH484/2.+Need+Theories> accessed 16th July 2016)

From another perspective, as the process of hierarchy of needs reflects different levels of needs and therefore, diligence to achieve a specific type of the needs can be observed from company directors' behaviour, which ultimately might be problematic towards achieving the objective of creativity. This can be seen under the legal regime of duty of care in the absence of judicial or legislated deference of which, rather than primarily focus on creativity that justifies judicial or legislated deference (as being currently shown in the Companies Act 2006), the law requires directors to primarily focus on exercising 'due diligence' up to the objective standard of a 'reasonable man'; or act within the realm of objective standard of 'reasonableness' respectively, in order to avoid the threat of negligence liability. Furthermore, the uncertainty relating to the application of the standard of a reasonable man as argued by academic writers such as Greenhow[713]; Davis[714]; Bainbridge[715]; and Gardner[716], yield a greater risk of incurring the liability and thereby, gives rise to a stronger crave psychologically for safety needs above any other higher needs amongst Maslow's' Hierarchy.

In addition, the threat of holding a company director liable for his negligence due to the poor outcome of his business judgment may result in an increase of diligence. However, as the theory of hierarchy of needs dictates, that there can be a different type of diligence serving different level of needs. A person, therefore, needs to

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[713] Annete Greenhow, 'The Statutory Business Judgment Rule: Putting the Wind into Directors' Sails' (1999) BondLawRw Vol 11, 42

[714] KB Davis Jr, 'Once More, The Business Judgment' (2000) WIS.L Rev. 573, 582

[715] Stephen M. Bainbridge in 'Business Rule as Abstention Doctrine' (2004) 57 Van. L. RV. 83, 121

[716] John Gardner, 'Many Faces of the Reasonable Person' (Oxford University Research Archive 2015) < http://ora.ox.ac.uk/objects/uuid:9e724c9c-89c0-4ec0-bafd-4e3125081558> accessed 17th July 2016

understand that efforts must be made to ensure that the types of diligence can be selectively encouraged to meet the desirable result for the company.

Once again, referring back to the concept of types of diligence given by Conard, using the concept of motorist, Conard explained, 'Diligence in motorist may take in the form of watching more alertly to avoid impacts with other vehicles, or watching more alertly to avoid violating traffic rules such as stop signals, speed limits and median lines, or watching more alertly for police who might detect violation of traffic rules.'[717]

Likewise, different needs and diligence can be formed when it comes to company directors. As discussed above, the need for creativity - an end-product deemed to be associated with the advanced need in 'the motivation hierarchy' can only be achieved intrinsically by having all the basic needs being satisfied in advance.

MOTIVATION AND THE UK JUDICIAL DEFERENCE

In the section, I will discuss judicial deference under Part 11 of the Companies Act 2006 and the interrelation between the court's existing deferential approach, motivation and business creativity.

[717] Alfred. F. Conard, 'A Behavioural Analysis of directors' Liability for Negligence' (1972) Duke L J 904

After the abolition of the Wrongdoer's Control Rule by Part 11 of the Companies Act 2006, the courts are now prepared to entertain derivative action. However, company law's interference can only be invoked on the basis that the derivative action can be justified by way of good faith, initiated in the interest of the company.

This in turn, broadens the scope of judicial/legislated deference through a list of non-exhaustive factors (both legal and business factors) that can be taken into account by the court.

In recent cases such as *Wishart v Castlecroft Securities Ltd*[718]; and *Kleanthous v. Paphitis*[719] judges have repeatedly expressed the significance of business creativity through the recognition that judicial intervention of directors' Non-Programmed (Creative) Business Decisions would result the companies in question in losing their directors. These 'commercial factors' (the term used by the judges to distinguish from 'legal factors' - *Iesini v. Westrip Holdings Ltd* [2009] per Lewison J[720]) were considered to have the consequence of reducing the directors' business creativity which in turn, damaging the companies' future trade performance. These cases are presented with principles that confirm that the law recognizes the negative effect of

[718] [2009] CSIH 63 (CSIH)
[719] [2011] EWHC 2287 (Ch)
[720] *Iesini v. Westrip Holdings Ltd* [2009] EWHC 2526 (Ch) 80 (also as cited in Kershaw, *Company Law in Context: Text and Materials* (2nd edn. OUP Oxford, 28 Jun. 2012) 615-616)

controlling extrinsic motivator or the negative effect of legal punishment on directors' business creativity.

In the case of *Iesini v. Westrip Holdings Ltd,* the judge acknowledged that the commercial factors represent part of the factors in Section 172, he refused to take those factors into account for the purpose of section 263(2)(a) on the ground that 'judges are ill-equipped to take'[721] and as already established in Chapter Three, the term, 'judges are not equipped to take' was not meant in the traditional sense referring to business expertise of judges; rather, it refers to the rigidity of the judicial system that results in judges being psychologically less business creative than company directors. In other words, from a psychology perspective, it can be said that, as opposed to company directors, judges are not intrinsically motivated to be business creative.

The legal recognition of the broad spectrum of which a controlling extrinsic motivator can be invoked is deeply embedded to the point that even if judges cannot be certain what constitutes commercial factor under Section 263(2), judges would still have the non-exhaustive list of factors that the judge is required to take into account in exercising such discretion. And as pointed out by Gibbs, Keay and Loughrey that the court would therefore, be able to take all relevant considerations into account.[722]

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[721] ibid [85]

[722] Gibbs, 'Has the Statutory Derivative Claim Fulfilled its Objectives? A prima Facie Case and the Mandatory Bar: Part 2' (2011) Co Law 81; and Keay and Loughrey, 'Something Old, Something New

The court's right to the non-exhaustive list under section 263 was affirmed by the court in a recent case known as *Stimpson v Southern Landlords Association*[723] to include a hypothetical director acting in good faith. This is in line with section 172. Following the non-exhaustive list of factors available to judges, it can be said that the common law approach of judges refusing to second guess the managerial discretion of the board remains a factor. In other words, the common law rulings as seen in *Howard Smith Ltd v. Ampol Petroleum Ltd*[724]; *Smith v Croft (No. 2)*[725]; and *Extrasure Travel Insurances Limited v. scattergood and Others*[726] that judges are ill-equipped to assess a commercial factor would first be applied on a subjective good faith basis to ignore section 263(2)(a) as seen in *Lesini*, and would also be likely (due to judges' diffidence in interfering with corporate management) be a factor for the judges to exercise their discretion to discontinue the derivative claim under section 263(3)(b).

As already demonstrated in both Chapter Three and this chapter, directors' business creativity and the psychological impact on such creativity as a consequence of the derivative claims would logically represent a commercial factor that essentially justifies the court's diffidence. Hence, legislated deference. To achieve a complete

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and Something Borrowed' (2008) 124 LQR 469, 473; and Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 620

723 [2010] BCC 387 (Ch) (as cited in the case comment 'Stimpson v Southern Landlords Association: Permission to Continue Derivative Claim Refused' (2010) Co. L.N.277, 283-284; see also Tang, 'Shareholders' Remedies: Demise of the Derivative Claim?' (2012) UCL, 182

724 [1974] AC 821 (PC)

725 [1988] Ch 114 (Ch)

726 [2002] 1 BCLC 598, (Ch) [90], [97]

understanding of this argument, it is essential to also focus on the types of business decisions which will be explored fully in Chapter Five leading to the final conclusion.

SUMMARY

Psychology researchers have long found that an individual's intrinsic motivator being the key element to his/her creativity. On the other hand, extrinsic motivation, in particular, controlling extrinsic motivation has been constantly found to be detrimental to one's intrinsic motivation which would eventually lead to block of creativeness. Under the observation of the current thesis, it can be argued that any legal regime strictly based on negligence liability without an appropriate judicial or legislated deference in place, within the context of company directors' business decisions, constitutes a controlling extrinsic motivator which is detrimental to directors' business innovation.

It has been argued that extrinsic motivator can only be adopted to enhance intrinsic motivation that leads to creativity if the extrinsic motivator is properly managed. My research has established that the enabling extrinsic motivator does not need the proposed management within this research context. This is because the 'withdraw symptoms' of the external reward does not apply to the setting of company directors in their business decision making-process. This is due to the fact that the outcome of the creative business idea is unknown or uncertain, which in turn renders the external rewards not coming by choice. Furthermore, under the usual circumstances, the external rewards go to the company, not the individual director. Therefore, the chance

of the directors' intrinsic motivation be diluted by enabling external motivator does not exist.

The benefit of proper management of extrinsic controlling motivator does not apply to company directors under the research scenario as controlling regulations do not co-exist with creativity. The argument to overcome controlling extrinsic motivator by proper management is further evaporated when one considers company directors having the options to implement business decisions which allow them to be risk-adverse through the exercise of different types of due diligence - due diligence not exercised for creativity but for self-protection.

However, the 'management' argument can be applied to a different type of business decision made by directors within the concept of types of decision postulated by H.A. Simon. Coupled with the necessity to accurately define the condition of 'novelty' within the definition of creativity, this would then lead to the necessity of having the entire Chapter Five dedicated to the types of business decisions in order to complete the examination of the UK law based on my proposed concept of Non-Programmed (Creative) Business Decisions.

My research has also found that judges (irrespective of their business knowledge) are not intrinsically motivated to be creative as opposed to company directors due to the existing concept of different occupation leads to different problem-solving approach. This explains the reason as to why company directors are in the position to make

business decisions for the company whereas judges are not, even though both sides can be business or non-business experts. This in turn, supports the conclusion in Chapter Three that the justification for judicial or legislated deference should be based on creativity of directors' business decisions and not on the traditional understanding of questioning the amount of business expertise of judges.

To apply the psychology theory of motivation on the UK law, this research argues that the current UK legislated deference regime under the Companies Act 2006 excludes controlling extrinsic motivator; and generates an intrinsic motivator which has the beneficial effect on the motivation of company directors' business creativity.

Finally, the importance of intrinsic motivation to company directors' business creativity through the application legislated deference under the Companies Act 2006 can be further supported by the theories of locus of control and Maslow's Hierarchy of Needs. These theories also serve as an additional evidence to support the conclusion in Chapter Three, i.e., the real justification for judicial deference does not lie on the business expertise of judges; rather, it lies on the issue of business creativity that stems from different needs and priorities of directors and judges resulting in different levels of psychological limitations via bounded rationality; and understanding in business creativity.

One of the aims of this research is to put forward a new perspective in understanding the justification of judicial or legislated deference in favour of company directors' business decisions. Another aim is to adopt the normative approach. This is done by evaluating business creativity as the justification of the law; and the psychological value of the law in motivating directors' business creativity. This chapter is built, with Chapter Three serving as a foundation, to further demonstrate that the traditional argument of the factor relating to judges' business expertise is a faulty assumption; rather, the real justification on judicial or legislated deference is actually based on creativity relating to company directors' business decisions. In doing so, this chapter has demonstrated (by adopting the studies in the field of economics) the significance of creative business decisions to corporations. This has led to the conclusion that ignoring business creativity would be a seriously misjudgment in this increasingly competitive global business market.

Creativity in the context of company directors' business decisions is not an established concept in UK company law. To overcome this research limitation, I have broadened my research to include the fields of psychology and management of which vigorous studies have been conducted in creativity. This cross-disciplinary research enables me to formulate a definition of creativity on which the psychology theories can be used to assist judges to identify directors' creative business decisions on which judicial or legislated deference is to be based; and to express proper justification of

judicial or legislated deference. However, this chapter alone does not complete the entire part of my proposed concept, as my proposed definition of creativity combines H.A. Simon's concept of types of decisions. The concept of types of business decisions needs to be relied upon to offer a complete alternative analysis of the distinctions of directors' decisions that is business judgment and decisions that are not business judgment. In addition, this psychology concept of creative type of business decision needs to be vigorously discussed and 'experimented' through legal case studies in the next chapter.

Chapter Four explores the essential interrelation between company directors' creativity and motivation. Through these studies, I have demonstrated the importance of judicial or legislated deference within the context of directors' business decision. From a psychology perspective, without the legal protection to insulate company directors from negligence liability, the law can be a controlling extrinsic motivator that destroys directors' level of creativity. This in turn, would have negative impact on the company's business competitiveness and the country's economy as a whole.

This chapter also explores specifically into the interrelations between motivation, business creativity and current legislated deference (sections 263(2)(a) & 263(3)(b) of Part 11 of the Companies Act 2006); and how the derivative claim regime (built on the presumption on the appropriate application of judicial deference on directors' business judgment) under the Companies Act 2006 as a whole has been formulated bearing the characteristics very much in line with these psychology concepts of

motivation and creativity (within the context of company directors' business decisions).

Finally, as briefly mentioned above, this chapter leads to the next chapter on the research being undertaken to explore the types of business decisions. In doing so, judicial or legislated deference and negligence liability are being applied (in the UK law) to different types of business decisions without the danger of de-motivating directors' business creativity. A type of business decision known as Non-Programmed (Creative) Business Decision will be formally identified and explored. Thereafter, case studies on the types of business decisions within the context of directors' business decision-making will be conducted towards the end of Chapter Five. This leads to the conclusion that the company law's deference, from a psychology perspective, has been appropriately applied by the courts, based on types of business decisions, with the positive result in motivating company directors' business creativity.

CHAPTER FIVE - TYPES OF BUSINESS DECISIONS WITHIN THE CONTEXT OF JUDICIAL AND LEGISLATED DEFERENCE

'We need to construct not a single theory of organization but two bodies of theory, one of them applicable to programmed decision-making and the other applicable to non-programmed decision-making.'[727] – Herbert A. Simon.

CHAPTER INTRODUCTION

In Chapter Two, I discussed the UK common law judicial deference; the codification of the common law into the Companies Act 2006; and the mechanism of legislated deference operated based on a specific type of business decisions, i.e., business judgment as opposed to directors' functional responsibilities.

In Chapter Three, I pointed out that the justification of such a deferential approach was actually based on company directors' business creativity as opposed to the traditional understanding of questioning the degree of business expertise of judges.

In Chapter Four, I proposed a definition of creativity (a version of definition borrowed from the psychology definition of Product-Oriented Measure of Creativity); the significance of creativity to companies from an economics perspective; the

[727] Cited by Earl Latham, 'Research Frontier in Politics and Government: Booking Lectures, 1955 by Stephen K. Bailey, Herbert A. Simon, Robert A. Dahl, Richard C. Snyder, Alfred De Grazia, Malcom Moos, Paul T. David, David B. Truman' (1956) Am Political Sci Rev Vol 50, No 2, 545

inherent link between motivation and creativity; and finally, how the deferential approach under the Companies Act motivates company directors' business creativity.

So far, the principles that have been established are:

- the legislated deference has only been available to protect directors from bad results as a consequence of their business creativity rather than functional responsibility/corporate governance functions or, as this chapter will classify, from a psychology perspective - programmed business decisions[728]; and

- that the conditions of 'novelty' and 'usefulness' as elements of the psychology definition of creativity. Whether or not a business decision is a creativity decision from a psychology perspective will depend on the full satisfaction of these two elements.[729]

This chapter will explore creativity with greater details by using the concept of the types of business decisions. This chapter will, in particular, use H. A. Simon's theory of programmed and non-programmed business decisions; together with hybrid and 'evolution' of types of business decisions to demonstrate, from a psychology perspective, how the law operates; and how the law should operate within the context

[728] Functional Responsibility is a generic term given by Reed in 'Company Directors – Collective of Functional Responsibility' (2006) Com Law, 172 to describe business decisions that do not satisfy the elements of creativity, for instance, the responsibility required by law to acquire the skills expected to be relevant to the company's business (*Dorchester Finance Company v. Stebbing* [1989] BCLC 498 (Ch)). This is closer in line with the programmed decision, a type of decision which must be made within the pre-defined rule.

[729] To put it simply, the conditions of novelty and usefulness require freedoms in the director's decision-making process.

of company directors' business decisions. In other words, looking at the law from a psychology perspective, this chapter classifies directors' business judgments as Non-Programmed (Creative) Business Decisions; and this chapter classifies directors' functional responsibilities or corporate governance functions as programmed business decisions.

In addition, the overall aim of this Chapter is not only limited to the identification of, from a psychology perspective, the types of business decisions. Steps have also been taken to examine how the types of business decisions apply to the already discussed the theory of creativity in psychology. This will formulate the final proposed theory of Non-Programmed (Creative) Business Decisions, i.e., a modified psychology term to describe business judgments.

This chapter will use a number of selected UK and US cases as case studies to look into the types of business decisions from a perspective of the psychology theories. In doing so, this chapter will demonstrate that the company law's deference produces psychology effect of promoting directors' business creativity.

TYPES OF BUSINESS DECISIONS

As already been pointed out in Chapter Three, unlike the traditional argument in favour of company law's deference pointing to the ground of 'the judges are not business experts'. The actual justification of company law's deference is based on

directors' business creativity. This is distinguished by the types of business decisions. This argument demonstrates that even business expert judges can be 'ill-equipped' to place themselves in the positions of company directors in dealing with certain types of business decisions. The complexity of directors' business judgment for judges to be able to fully comprehend, regardless the level of their business expertise. This new perspective also opens up to a different spectrum in showing the judges' understanding on how the law is to be operated in the best interest of the company. This can only be achieved through encouraging directors to take business decisions involving creative and venturesome business activities without the fear of incurring personal liability.[730] In other words, as Chapter Four demonstrates, the company law's deference based on the types of business decisions[731] prevents the judicial system from operating as a controlling extrinsic motivator.

In order to properly explore the types of business decisions, one must first answer the question as to what is a 'decision'. Therefore, it is necessary to first define a 'decision' from an academic point of view.

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[730] Carlos Andres and Laguado Giraldo, 'Factors Governing the Application of Business judgment Rule: An Empirical Studies of US, UK, Australia and The EU' (2006) 122 < http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.542.5943&rep=rep1&type=pdf> accessed 24 February 2018; See also l. Denis Ping, 'The Business Judgment Rule: Should it Protect Non-Profit Directors?' (2003) 103 Colum L Rev 946; and see also, Demetra Arsalidou, 'Objectivity vs. Flexibility in Civil Law Jurisdictions and the Possible Introduction of the Business Judgment Rule in English Law' (2003) Co Law 24(8) 228-233

[731] For how extrinsic motivator decreases intrinsic motivator on scientific terms, see for instance, Amabile T.M. and Cheek J.M. 'Commentary Essays on Findlay and Lumsden's The Creative Mind: Toward an Evolutionary Theory of Discovery and innovation' (1988) J Social Biol Strut 59

Academic writers Teale *et al.* have cited a number of academic writers' statements defining a 'decision' in their book;[732] and they include – 'Acts of choice between alternative courses designed to produce a specified result, and one made on a review of relevant information guided by explicit criteria.' – Rose, quoted by Weeks in Salaman and Thompson, 1980:187;

> A conscious and human process, involving both individual and social phenomena, based upon factual and value premises, which includes a choice of one behavioural activity from one or more alternatives with the intention of moving towards some desired state of affairs.' – Shull *et al.* in Harrison, 1999:4.; and
>
> A moment, in an ongoing process of evaluating alternatives for meeting an objective at which expectations about a particular course of action impel the decision maker to select that course of action most likely to result in attaining the objective. – Harrison, 1999:5.[733]

Richard Prentice has also given an in-depth definition of decision as:

> The delimitation of goals and their specification as objectives; the recognition of problem (the recognition that objectives are not be attained); the search for

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[732] Mark Teale et al. *Management Decision-Making Towards an Integrative Approach* (1st edn, Financial Times/Prentice Hall 2002) Chapter 6

[733] ibid

> possible strategies to solve this problem; the prediction of consequences of these strategies in relation to the predicted strategies of an environment (the set of opponents); the evaluation of strategies discovered in the context of extent to which the anticipated consequences obtained the objectives; the selection of strategies on the basis of the evaluation; the implementation of that strategy and the monitoring of the consequences of the intervention.[734]

Looking at the above definitions from a broad perspective, a general consensus of a 'decision' encompasses the elements of evaluation and selection of choices with an aim to achieve a specific objective or objectives. This indicates both the process of decision-making as well as the final decision itself.

As the main focus of my research is based on the decision taken by a company director in the process of operating the company's business, a further step is taken to define a decision from within the context of corporate business.

As academic writers have yet to produce a direct definition relating to decisions taken within the company business context, i.e., 'business decisions', I have attempted to seek to place my reliance on the relevant statutory definition. Unfortunately, I have not been able to trace any relevant definition within the UK and the US legislation. I therefore, would rely on my general perception of what a business decision is, drawn

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[734] P Prentice, 'The Theory of Games and Conceptual Framework for the Study of Non-Programmed Decision Making by individuals?' (1975) Area Vol 7 No 3 161

from the UK and the US case law. Through which the simplicity of establishing the nature of business decisions can be seen, namely, the involvement of elements of evaluation and selection of choices with an aim to achieve a specific objective that are relevant to the operation of the company's business or activities. See for instance, director evaluating and selecting options in the context of supervision of the job performance of his subordinates as part of the internal control of the operation of the company's business (*Equitable Life Assurance v. Bowley*[735]); a hypothetical director evaluating and selecting options on whether or not to pursue a derivative claim, in an attempt to prevent any disruption to the Company's business (*Iesini v. Westrip Holdings Ltd*[736]); or (in an US case law) evaluating and selecting options on whether or not to include a severance compensation clause in the directorship contract (*Re. Walt Disney Company Derivative Litigation (Disney V)*[737]). The business decisions demonstrated in the above cases are of strategic nature, Keay and Loughrey have, in their recent article, pointed out the UK courts' historical recognition of business decisions from perspective of the dictionary meaning of 'commercial'.[738] Their interpretation of the meaning of the word 'commercial' is backed up by reference to

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[735] [2003] EWHC 2263 (QB) [41]
[736] [2009] BCC 420 (Ch) [85]
[737] 907 A 2d 693 [2005]
[738] *Cobden Investments Ltd v. RWM Langport Ltd [2008] EWHC 2810 (Ch); Moxon v. Litchfield [2013]3957 (Ch)* and *ARB International Ltd v.Bailie [2013] EWHC 2060 (Comm)* all cited by Keay A & Loughrey J, 'The Concept of Business Judgment' Legal Studies 1, 10 < https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019

the Oxford English Dictionary, i.e., 'the activity of buying and selling'.[739] However, the reliance of the dictionary meaning of the word, 'commercial' appears to offer a limited scope within the context, as in some cases, the judges have decided that directors' commercial decision goes beyond activities of mere buying and selling. For instance, in *Kleanthous v. Paphitis,*[740] the judge held that a director's decision to discontinue a derivative claim for avoiding disruption to the group dynamics of the company's employees; and/or damage to the reputation of the company would constitute a commercial decision.

To strengthen the understanding of what constitutes a business decision in the context of company directors' decisions, reference is drawn to Australian law - a legal jurisdiction that operates a concept of judicial or legislated deference similar to UK and US company law. Australian law defines a business decision as '... any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation'.[741]

The UK and the US case laws, as well as, the Australian statutory definition do not initially define what a decision is. Therefore, for the purpose of this research, the

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[739] Oxford English Dictionary at http://www.oed.com/view/Entry/37081?redirectedFrom=commercial#eid as cited by Keay A & Loughrey J, 'The Concept of Business Judgment' Legal Studies 1, 10 < https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019

[740] [2011] EWHC (Ch) [71], [72] & [75]

[741] Corporations Act 2001, Section 180(3)

word, 'decision' within the context of business decisions that is drawn from both the UK and the US case law and the Australian statutory definition will be based on the earlier quotes of the academic definitions of 'decisions'. To sum up, a business decision can simply be defined as evaluation and selection of choices with an aim to achieve a specific objective(s) for operation of a company' or companies' business.

However, for the purpose of this research, it is insufficient to solely place the reliance on the above definitions. As pointed out by Teale et al.[742] that there are problems or difficulties in defining a decision (a business decision in the present context) to suit a given situation. For the purpose of this research, an example of the difficulties could be a situation where a judge is being presented with a case whereby, he or she is to decide whether or not a particular business decision warrants the protection of judicial or legislated deference. In other words, the term, 'decision', and in the context of this research – 'business decision', is conceptual and when in operation, can take a variety of forms.

This means that a business decision can be 'varied and multi-faceted and, whilst we may identify elements of a decision that may be common to other decisions, it does

[742] Mark Teale et al. *Management Decision-Making Towards an Integrative Approach* (1st edn, Financial Times/Prentice Hall 2002) Chapter 6

not necessarily follow that all decisions are similar in nature'.[743] This gives rise to a need to identify business decisions by way of their types.

NON-PROGRAMMED BUSINESS DECISIONS

As briefly mentioned throughout the previous chapters, there are a number of types of business decisions. The first type of decisions is known as Non-Programmed or Unstructured Decisions which was first properly and fully classified by H.A Simon in 1965.[744] A non-programmed or unstructured decision is as described by its name, i.e., that the decision is unclear, ambiguous and insufficiently or completely not predefined.

Academic writer, Harrison has called a non-programmed or unstructured decision a category II decision which, along with other conditions, is 'non-routine, non-recurring and uncertain'.[745]

Similarly, Venkatachalam and Sellappan described a non-programmed decision as '…novel and unstructured. No rule, routines, or standard operating procedures can be developed to handle them. Solutions must be worked out as problems arise.'[746]

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[743] Mark Teale et al. *Management Decision-Making Towards an Integrative Approach* (1st edn, Financial Times/Prentice Hall 2002) Chapter 6

[744] See generally H.A. Simon, *The New Science of Management Decisions* (Prentice Hall 1965)

[745] As cited by Mark Teale et al. *Management Decision-Making Towards an Integrative Approach* (1st edn, Financial Times/Prentice Hall 2002) Chapter 6

[746] Venkatachalam and Sellapan, *Business Process* (Prentice-Hall of India Pvt. Ltd 2011) 115

Soelberg has given a more detailed account of the uncertainty that relates to non-programmed decision by stating that:

> …that decision maker applied a few special-purpose decision rules when arriving at his choice; that a number of decision criteria that he (decision maker) applied were initially un-operational; that many of the choice alternative he considered were unknown to start with; that information about the alternatives' consequences and their relative worth was not immediately available from the task environment; and that decision maker might not even be able to specify the nature of an ideal situation to his problem.[747]

As there have been a number of terms describing the above type of decision, for the purpose of simplification in the following discussions, only the term - non-programmed decisions will be used from now and throughout the chapter, with the exception of quotes from third parties.

According to H.A. Simon and other academic writers such as Griffin and Moorhead, non-programmed business decisions are risky and yielding big impact on the company's business. [748] And Soelberg pointed out the creative nature of non-programmed decisions by commenting that:

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[747] Peer Soelberg, *Unprogrammed Decision Making* (MIT, 1967) 239-67, 240

[748] *Ricky W. Griffin & Gregory Moorhead, Ricky W. Griffin & Gregory Moorhead on Organizational Behaviour: Managing People and Organizations* (South-Western College Pub 2010) 192

> But if you ask him directly, decision maker would insist that the un-programmed problem confronting him had to be solved in its own unique context … yet it is precisely this type of non-programmed decision making that forms the basis for allocating billions of dollars' worth of resources in the economy every year.[749]

This comment supports the research conclusion presented in Chapter Four which stresses the significance of business creativity (non-programmed nature) to companies from an economics point of view.

From a business point of view, to be effective in making a non-programmed business decision, directors are required to conduct market research including evaluating intricate issues, analysis alternatives and making strategic decision that bears significant consequences for the company. Therefore, an effective non-programmed decision is very difficult (and requires more thoughts) to make, especially when the decision has to be made within a short period of time. See for instance, Emmanuel et al who describe non-programmed decision making as 'one contingent variable' to the proper performance of single accounting information system within companies, and '… the multi-divisional company was chosen to exemplify the difficulties or applying

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[749] Peer Soelberg, *Unprogrammed Decision Making* (MIT, 1967) 239-67, 240

conventional accounting systems because of high incidence of non-programmed decision making.'[750]

The complexity and uncertainty of success of non-programmed business decisions has also been stressed by writers Venkatachalam and Sellappan, both stated that:

> The creation of an organization's strategy involves non-programmed decision making by managers who experiment to find the best way, to use an organization's skills and resources to create value and who never know in advance whether they are making the right decision.[751]

It follows that, the undertakings of non-programmed business decisions in a company often require the employment of resources of which the company can offer. By linking this to the discussion in Chapter Three, places company directors in positions that make them less boundedly rational in their decision-making process as opposed to judges. As judges are bound by the strict judicial budgets and constrains, all aim to streamline the courts' system as opposed to companies' business. This in turn, renders the judicial system relatively less resourceful than corporate environment.

The difficulty in non-programmed decision-making is backed further (and in greater details) by Cyert et al through their intricate analysis of the rational process of general

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[750] Clive Emmanuel and David Otley, *Accounting for Management Control* (2nd edn, Change Learning EMEA 1990) 357

[751] T A Sellappan and V M Venkatachamlam, *Business Process* (PHI 2010) 115

decisions; and followed by breaking of general decisions into elements of which the related information can be ill-defined. Thereby gives rise to the distinction between; and the reasons for the existence of both programmed and non-programmed types of decisions:

> In economics and statistics, the rational choice process is described somewhat as follows:
>
> 1. An individual is confronted with a number of differences, specified alternative courses of action. 2. To each of these alternatives is attached a set of consequences that will ensue if that alternative is chosen. 3. The individual has a system of preferences or 'utilities' that permits him to rank all sets of consequences according to preference and to choose that alternative that has the preferred consequences. In the case of business decisions, the criterion for ranking is generally assumed to be profit.[752]
>
> If we try to use this framework to describe how real human beings go about making choices in a real world, we soon recognize that we need to incorporate in our descriptions of the choice process several elements that are missing from the economic model:

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[752] Richard Cyert et al, 'Observation of A Business Decision' (1956) J Bus 237

> 1. The alternatives are not usually 'given' but must be sought, and hence it is necessary to include the search for alternatives as an important part of the process. 2. The information as to what consequences are attached to which alternatives is seldom 'given', but instead, the search for consequences is another important segment of the decision-making task. 3. The comparisons among alternatives are not usually made in terms of simple, single criterion like profit. One reason is that there are often important consequences that are so intangible as to make an evaluation in terms of profit difficult or impossible. In place of searching for the 'best' alternative, the decision maker is usually concerned with finding a satisfactory alternative – one that will be attained specified goal and at the same time satisfy a number of auxiliary conditions. 4. Often, in the real world, the problem itself is not a 'given', but, instead, searching for significant problems to which organizational attention should be turned becomes an important organizational task.[753]

It is interesting to point out that the position above is similar, but not completely in line with the 'usefulness' condition of the Product-Oriented Measure of Creativity in the context of directors' business decisions. In particular, as we can see, the objective of searching for the 'best alternative', as described in point 3 above, can be said to be similar to - 'an aim to benefit' within the provision of the 'usefulness' condition of the creativity theory. However, in the former, the decision-making process usually

[753] ibid

involves the objective of searching for a 'satisfactory alternative[754]' without it being a specific requirement that the decision has to be useful. In other words, it is not an essential condition to establish a non-programmed decision to always benefit any party or towards problem-solving; whereas the latter, places an essential emphasis on the process of decision-making, with the intention, based on the subjective element of good faith, i.e., the decision must be made in good faith with an aim to benefit the company. This difference, couple with the classifications of types of business decisions, render the combined research of the law; the psychology theory of creativity; and the theory of types of decisions essential in achieving completeness and clarity for the purpose of this thesis.

And as discussed in the previous chapter, in order for a decision to be creative, it has to be 'useful', i.e., the business decision made bona fide with an intention to benefit the company. Therefore, this renders the issue relates to the end quality of the decision immaterial. This principle applies strictly on a business decision that constitutes a Non-Programmed Business Decision within the context of creativity. This coincides with the subjective element in the legal process of determining whether or not deferential approach should be taken by the court in directors' favour under section 263(2)(a). In which the court is to decide on whether or not the decision was made bona fide by the director acting as an appropriate independent organ of the company; and in the interest of the company (the conditions as seen in the cases such

[754] ibid

as *Smith v. Fawcett*[755]; *Extrasure Travel Insurance Ltd v. Scattergood & Others*[756]; and *Stimpson v Southern Landlords Association*[757]). The law concludes that the element of 'the end quality of a decision' is not a condition to establish Non-Programmed (Creative) Business Decision.[758]

Overall, as generally pointed out in Chapter Three, the theory of creativity represents a broader and more in-depth study that relates to creativity. For instance, the theory dictates the requirement of company directors acting in good faith, in the interest of the company as a pre-condition of 'usefulness'.[759] The creativity theory enables my research to cover its inter-related subject, i.e., motivation. That allows me to demonstrate the differences between non-business expert judges and non-business expert directors with a view on how the law has been formulated to motivate company directors' creativity in decision making. However, creativity itself does not clearly define and categorize the types of business decision which all represent essential components of this research. These components are aiming to give, from a psychology perspective, an overall view of the company law's deference in the context of motivating directors to be business creative. Hence, my research

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[755] [1942] 1 CH 304 (CA) 306

[756] [2002] BCLC 1 (Ch) [90], [97]

[757] BCC 387 (Ch) (as cited in the case comment, 'Stimpson v Southern Landlords Association: Permission to Continue Derivative Claim Refused' (2010) Co Law 277, 283-284; see also Tang, 'Shareholders' Remedies: Demise of the Derivative Claim?' (2012) UCL 182

[758] See generally H.A. Simon, *The New Science of Management Decisions* (Prentice Hall 1977); Richard Cyert et al, 'Observation of A Business Decision' J Bus 237, 238; and See Ricky W. Griffin & Gregory Moorhead, *Organizational Behaviour: Managing People and Organizations* (10th edn, South-Western College Pub 2010) 192

[759] Andrall E. Pearson, 'Tough-Minded Ways to get Innovative' (May/June 1988) HBR 99

combines the mutually complimentary theories of Product-Oriented Measure of Creativity and Types of business Decisions. This combination will deliver a new model ensuring clarity in explaining the suitability for applications of judicial or legislated deference concerning company directors' business decisions. Consequently, I will name my proposed model of business decisions as Non-Programmed (Creative) Business Decisions.

From a traditional law academic point of view, law academic writers do not use the term non-programmed business decision in their writings. They nevertheless appreciate the justification of judicial deference offered by the judges in *Dodge v. Ford Motor Co;*[760] or *Overend Gurney & Co v. Gibb*[761] through the recognition of the creative nature and unpredictability of such type of business decisions. For instance, Fischel has described non-programmed business decisions with the characteristic that:

> The range of future contingencies may be unforeseeable. Alternatively, even if it is foreseeable, the desired responses to future contingencies may be unknown initially. Attempt to define desired responses to future contingencies will have to change overtime in light of new information.[762]

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[760] [Mich 1919] 170 NW 668

[761] LR 5 (HL) 580 cited by Moore on *Corporate Govenance in Shadow of State* (Hart Publishing, 2013) in support of the UK historical existence of UK judicial deference justified by the unpredictable nature of directors' business decisions.

[762] Daniel R. Fischel, 'The Business Judgment Rule and Trans Union Case' (1985) BL Vol 40, 1440

In the following, I will further elaborate non-programmed business decisions by first using some hypothetical examples. This would give a broader view on the scope of the proposed concept. This would then lead to an experiment on the applicability of the concept of the types of business decisions in legal scenarios through case studies based on the actual law cases, all will be undertaken at the end of this chapter.

HYPOTHETICAL ANALYSIS

A director of a company had to make a non-programmed business decision regarding the development and selling of smart-phones[763] or transgenic beans[764] which would include exploring the new idea; researching the new technology; selecting the right segment of the markets; and employing the right advertisements to promote this new product to the consumers.

As discussed in Chapter Four, as well as the earlier part of this chapter, this decision-making process satisfies the conditions of Product-Oriented Measure of Creativity by way of its 'novelty' and 'usefulness', as the business idea is non-programmed or ill-defined, with an aim to benefit the company.[765]

The difficulties to the directors in the decision-making process are that the creative concept and marketability of smart-phones or transgenic beans to the general public

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[763] Samsung Electronics (UK) Limited v Apple Inc. [2012] EWHC (Ch) as mentioned in Chapter Four – Case studies number one

[764] *Bowman v Monsanto Co*. 596, U.S. [2013] as mentioned in Chapter Four – Case studies number four

[765] Kanter, *The Change Masters* (New York: Simon and Schuster 1983) as cited by Teresa M Amabile, 'A Model of Creativity and Innovation in Organization' (1988) Res Organ Behav, Vol 10, 167; see also.

or the farming industry (respectively) are unique. Hence, the relevant information is either very limited or ill-defined at first. Consequently, a non-programmed decision entails the elements of high risk-taking and uncertainty,[766] but at the same time, they are aimed to deliver a long-term impact on the success of the company's business.[767] It follows that, this type of business decision involves a high level of executive judgment and deliberations taken at the board level.

Linking the above analysis to Chapters Two, Three and Four. One can see from a psychology perspective, the inter-connection between creativity and non-programmed business decisions; and that the reason of judicial or legislated deference being justified to protect the directors and to promote business innovation (with the exception of cases where the directors were grossly negligent in the process of making the non-programmed business decision[768]; or where there is a conflict of interest between the directors and their company). This means that the directors must ' … neither appear on both sides of the transaction nor expect to derive any personal benefit from it in the sense of self-dealing, as opposed to benefit which

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[766] Theodore Kowalski & Thomas L. Lasley, *Handbook of Data-based Decision Making in Education* (1st edn, Routledge 2008) 8

[767] See e.g., Stephen M. Bainbridge, *The New Corporate Governance In Theory & Practice* (OUP USA 2008) 124; and Melvin A. Einsenbeg, 'The Duty of Care of Corporate Directors' (1989-1990) 51 U. Pitt. L. Rev. 958-959

[768] Smith v. Van Gorkom 488 A.2d 858 [Del. 1985] as cited by Douglas M. Branson, 'The Rule That Isn't Rule – The Business Judgment Rule' (2002) ART 3 631, 640

devolves upon the corporation or all the stockholders generally.'[769] This again demonstrates that, from a legal perspective, a non-programmed business decision by itself is not sufficient to invoke judicial or legislated deference without the essential condition of 'usefulness' in creativity being satisfied. Hence, the combination of creativity and non-programmed business decisions as this research proposes that results in a new model of business decision known as Non-Programmed (Creative) Business Decisions.

Going back to the factors, namely, conflict of interest or breach of duty of loyalty; that render a non-programmed business decision a non-creative decision (as described above). Quick and typical examples of conflict of interest likely to occur in the context of business decisions would include the situations as follows:

- As commented by the judges in *Norlin Corp v. Rooney, Pace Inc.,*[770] where directors are involving and implementing the strategy to resist a tender offer in a company takeover case, as directors would normally ' … act solely and primarily to retain control'[771] of the company.[772] A UK case similar to *Norlin* can be found in

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[769] Aronson v Lewis 473 A2.d at 812 [Del.1984] as cited by Charles Hanson in 'The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, a Commentary' (1985-1986) 41 BUS LAW 1237, 1248

[770] [2d Cir. 1984] 744 F2d 255 as cited by E. Norman Veasy & Julie M.S. Seitz, 'The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project – A Strange Porridge' (1985) 63 Tex L Rev 1489, 1483; See also Richard D. Truesdell, JR, 'Does Norlin Corp. v. Rooney Pace, Inc Preserve for Shareholders Control of a Corporation's "Ultimate Destiny"' (1986) 20 Colum J L & Soc Probs 325

[771] E. Norman Veasy & Julie M.S. Seitz, 'The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project – A Strange Porridge' (1985) 63 Tex L Rev 1489, 1483

[772] Thomas A. D'Ambrasio, 'The Duty of Care and the Duty of Loyalty in the Revised Model Business Corporation Act' (1987) 40 Vand L Rev 663, 678

Howard Smith Ltd v. Ampol Petroleum Ltd[773] where in an attempt to protect his future employment opportunity, the director unlawfully increased the company's shares with an intention to prevent a hostile takeover;

- Where a company director self-servingly withheld from the company the business opportunity of which it is commercially relevant for the company to know;[774] or

- Where a director purposely turning a blind eye through his or her failure to undertake an investigation into the activities likely to involve a fraudulent act of another fellow director who had happened to be his or her closely connected person, for instance, a close relative.[775] Again, apart from the case involving a clear conflict of interest on the part of the director, the director's business decision to refrain from intervening in a possible fraud case cannot be deemed to have been made 'usefully' or in the interest of the company. Therefore, such a decision will not constitute a Non-Programmed (Creative) Business Decision - an essential component of this chapter that has already been briefly covered above.

I shall discuss the related issue of gross negligence and conflict of interest in greater details in my case studies at the latter part of this chapter.

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[773] [1974] AC, 821 (PC)
[774] See *Bhullar v. Bhullar* [2003] EWCA Civ 424 (CA) [41]
[775] See *Lexi Holdings v. Luqman* & Others [2009] EWCA Civ (Ch) 117

Another hypothetical example that demonstrate a Non-Programmed (Creative) Business Decision can be shown on a situation where the director of a big car manufacturing company made a business decision to turn the company from being a plc to ltd.[776] The decision for such a change of the company's status was made with an aim to allow the company to avoid the pressure from the public who urge the company to constantly achieve the short-term goal. A change of the status, as the director believes, would allow the company to focus on more long-term research and development projects. Unless the director was acting in bad faith when making the business decision, the decision would constitute a Non-Programmed (Creative) Business Decision. This is because, from a psychology perspective, the business decision to change the status for overcoming the public pressure was not bound by any predefined rule (Novelty); and was aimed to benefit the company (Usefulness).

SUMMARY

In psychology, non-programmed decision is the types of decision that is, in the decision-making process, not bound by any predefined rule. Therefore, one can see a great element of uncertainty surrounding the outcome of the decision during the decision-making process. By putting the same concept into the context of directors' business decision-making, it can be described as non-programmed business decisions.

[776] See for instance, Tom Huddleston Jr, 'Elon Musk Says He Eants to Take Tesla at Over $70 Billion – Here is What that Means' (CNBC, 9 August 2018) <https://www.cnbc.com/2018/08/08/elon-musk-wants-to-take-tesla-private--heres-what-it-means.html> accessed 19 January 2019

This is because the decisions are of non-programmed in nature and involve evaluation and selection of choices with an aim to achieve a specific objective(s) for operation of a company' or companies' business.

From a relevant law perspective, although no such specific term of the types of business decision is used, one can see from the case law such as *Dodge v. Ford Motor Co;*[777] or *Overend Gurney & Co v. Gibb*[778] where the creative and unpredictability nature of such a business decision has been recognized by the courts in justifying judicial deference. This type of business decision is typically known, in law, as business judgment; or commercial decision that the court is not equipped to judge.[779]

Non-programmed business decision satisfies the 'novelty' condition of creativity in psychology. However, the concept of non-programmed business decision does not require the satisfaction of the second condition of creativity, i.e., 'usefulness'; and from UK company law perspective, the requirement that the business decision made by the director, in the interest of the company, within the provision of section 172 companies Act 2006.

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[777] [Mich 1919] 170 NW 668

[778] LR5HL 580 cited by Moore on *Corporate Govenance in Shadow of State* (Hart Publishing, 2013) in support of the UK historical existence of UK judicial deference justified by the unpredictable nature of directors' business decisions.

[779] See for instance, *Iesini v. Weststrip Holdings Ltd* [2009] EWHC (Ch) [80]

It follows that, the fusion of the concept of non-programmed business decision with the concept of product-oriented measure of creativity is essential to achieve a complete view of, from psychology perspective, business judgment.

PROGRAMMED BUSINESS DECISIONS

NOT every type of business decision is of unique and innovative nature. Therefore, a distinction between different types of business decisions together with how a business decision was originally made must be clearly drawn.

Another type of business decision that was also introduced by H.A Simon.[780] This is known as Programmed or structured Decisions, i.e., unlike the non-programmed business decision mentioned above, this type of decisions refers to the type that has been pre-programmed or to be made on routine, and repeated basis.[781] This type of business decision falls quite literally within the rational process of general decisions by Cyert[782] who was quoted earlier on. In other words, '… a decision rule or policy which tells a decision maker which alternative to choose once they have pre-determined information about the decision situation.' [783] Examples of programmed decisions include, handling employees' discipline against an employee who turns up to work late regularly; re-ordering office stationeries that involves

[780] See generally H.A. Simon, *The New Science of Management Decisions* (Prentice Hall, 1965)
[781] As cited by Mark Teale et al. *Management Decision-Making Towards an Integrative Approach* (1st edn, Financial Times/Prentice Hall 2002) Chapter 6
[782] Richard Cyert et al 'Observation of A Business Decision' (1956) J BUS Vol 29 No 4, 237
[783] See Ricky W. Griffin & Gregory Moorhead, *Organizational Behaviour: Managing People and Organizations* (Houghton Mifflin Company 2010*)* Chapter 8, 192

decision that is subject to the pre-set limitation of re-ordering; job allocations; production schedules; or company directors taking out an insurance policy on behalf of the company as shown in the case of *Re D'Jan of London Ltd*[784] (this case will be used in my case studies, towards the end of this chapter, indicating the interrelation with programmed business decision and the law).

For the purpose of simplification in the following discussion, only the term - programmed decisions will be used from now and throughout this chapter.

Unlike non-programmed decisions, a programmed decision can be easily adopted and readily applied by even a computer:

> … most famous scientific description of a case of highly programmed decision making is perhaps G.P.E. Clarkson's, in which it was demonstrated that the portfolio selection decisions made by a bank trust investment officer were so well programmed that his decisions could be predicted by a computer …[785]

PROGRAMMED BUSINESS DECISIONS TAKEN AT COMPANIES BOARD LEVELS

According to H.A. Simon and other academic writers such as Griffin and Moorhead, programmed business decisions are taken at the lower tiers of the

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[784] [1994] 1 BCLC 561 (Ch)

[785] See Peer Soelberg, *Unprogrammed Decision Making* (MIT, 1967) 3-16

organization and yield small impact on the company's business.[786] I would however, demonstrate with examples in the following parts of this chapter, that this particular assumption is faulty; and that programmed decisions can easily be taken at the top level of the organization which consequently bear serious impact on the company's business. Therefore, the presumption must be excluded as the key components of programmed business decisions for the purpose of this research.

The first example of a programmed decision taken at the upper tier of a company relates to a recent case, whereby the business decisions taken by company directors resulted in a great negative impact on a number of parties including the company, consumers and company's creditors is shown in the 2014 Taiwan food scandal case. The case involved the adulteration of cooking oil with recycled gutter (or waste) and animal feed oil that was not fit for human consumption. This case is being selected to demonstrate the situation demonstrating the involvement of company directors in the programmed decision-making process. Precisely, this case is selected due to its up-to-date and close relevance to the present subject-matter, i.e., programmed business decisions (resulted in a substantial impact to the company) made by company directors. The example is also used to fill the gap that has been left by certain academic writers when explaining the nature of a programmed business

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[786] See Ricky W. Griffin & Gregory Moorhead, *Organizational Behaviour: Managing People and Organizations* (Houghton Mifflin Company 2010*)* Chapter 8, 192; see also 'Programmed Decisions and Non-programmed Decisions Explained' < https://iedunote.com/programmed-decision-non-programmed-decision> accessed 2018

decision. For instance, the company's quality control example has been used to describe a programmed business decision by Cyert et al, in the absence of such description being supported by a real incident.[787] I shall therefore, use this case as a starting example to give an insight of programmed business decisions. A number of other examples will also be discussed following the first example to achieve a full picture of programmed business decisions made by directors.

In the 2014 Taiwan food scandal incidents, the directors of a number of companies who had purchased the non-human consumption oil (to be sold as cooking oil) from the manufacturer were accused to have secretly ignored the company's own internal sanitary control and safety procedures. It is believed that the directors had either been negligently trusted the raw oil supplier or because the directors had intended to achieve cutting down of the company's food production cost by a satisfactory margin.[788]

The directors have argued that they had not known nor had they been told by the raw materials supplier that those raw materials were of non-human consumption in nature. However, from the perspective of this thesis, it can be argued that due to the company (as its competitive marketing strategy) had promoted its own specific sanitary procedure prior to the food scandal incident; and the possibility of the directors'

[787] Richard Cyert et al 'Observation of A Business Decision' J Bus Vol 29, 237, 238

[788] HSU, Stacy, 'Hong Kong Edible Oil Imports Halted' *Taipei Times* (14 September 2014); 'Firm Sells Waste Oil as Cooking Oil' *The China Post* (6th September 2014); See also generally, Chen-Ling Huang 'Who Benefits from Food safety Incidents?' (2014) New Society for Taiwan <www.taiwansig.tw> accessed 2015

unconstitutional by-passing of the company's existing internal sanitary control. The internal sanitary control and safety system can be said to serve as a standard 'benchmark' where the directors 'can defend the quality of their business decisions by pointing to established protocol'[789] and the judges can 'use such protocol or practices as objective benchmarks to test the quality of the decisions'.[790] In addition, the question of creativity has been ruled out within the business decision, as it had been strictly based on a predefined internal sanitary system that does not satisfy the condition of 'novelty' within the Productivity Oriented Measure of Creativity Theory.[791] Therefore, as discussed in Chapter Two, the legal mechanism operates within the concept of judicial or legislated deference based on types of business decisions, led to the exclusion of judicial or legislated deference to the directors in question. This is so, because the directors were deemed to have made a programmed

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[789] Melvin A. Eisenberg, 'The Duty of Care of Corporate Directors and Officers' (1990) 51 U Pitt L Rev 945, 964

[790] Melvin A. Eisenberg, 'The Duty of Care of Corporate Directors and Officers' (1990) 51 U Pitt L Rev 945, 964; See also Annete Greenhow, 'The Statutory Business Judgment Rule: Putting the Wind into Directors' Sails' (1999) BondLawRw Vol 11, 42 for the importance of relying on standard 'benchmark' by the judiciary. **N.B.** The situation might have been different if the company prior to the food scandal incident announced to the public that a decision has been made that no internal sanitary check will be in place and thus, a complete trust to be placed on the raw material suppliers. In such as case, the business decision will not be considered as a programmed business decision as no pre-defined rule on which the decision to remove the internal sanitary system was based. In so far as Non-Programmed (Creative) Business Decision is concerned, (in the absence of any pre-existing legal requirement) such a decision might be regarded as a Non-Programmed (Creative) Business Decision unless it had not been made by the directors in good faith. However, if the quality control system was linked to the legal requirement, for instance, the Food and Safety law, the directors would still have been bound by a pre-defined rule set by the law. This links to what I am going to discuss at the part immediately following the present discussion.

[791] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organization' (1988) Res Organ Behav Vol 10, 125, 167; Robert T. Clemen and Terence Reilly, *Making Hard Decisions with DecisionTools* (3rd edn, South-Western College Pub 2013) 218; See also Sethi et al, 'Cross-Functional Product Development Teams: Creativity, and the Innovativeness of New Consumer Products' (2001) J Mark Res Vol 38, 73, 74

business decision, but they have failed to properly implement their programmed business decisions. In other words, it can be argued that if the directors failed to implement the company's predefined food quality controls procedure, such a failure would exclude the directors from the protection of judicial or legislated deference. This is because the predefined rule represents an essential component of a programmed business decision and must be strictly followed.

In addition, contrary to the standard academic view that programmed decisions bear the component of yielding small impact on the company's business,[792] the above example indicates that that such a programmed business decision was; and can be easily made directly by the companies' directors. Such type of business decision carries a long-term negative impact on the companies' business, e.g., short-termism to achieve cost-saving at the expense of the companies' long-term business reputation that led to the long-term negative impact on the companies' future business.[793]

Other than the straightforward case where the pre-existing policy is internally set by the company itself, H.A Simon's theory of a programmed decision generally refers to the decisions that have been pre-programmed or 'to be made on routine or repeated basis'.[794] This can also, by implication, refer to the situation where the predefined

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[792] See Ricky W. Griffin & Gregory Moorhead, *Organizational Behaviour: Managing People and Organizations* (South-Western College Pub 2010) 192

[793] 'FDA Releases List of Affected Companies' *Taipei Times* (6th September 2014): see also 'Sauce Maker Yillin Group Recalls Tainted Oil Products' *The China Post* (6th September 2014)

[794] As cited by Mark Teale et al. *Management Decision-Making Towards an Integrative Approach* (1st edn, Financial Times/Prentice Hall 2002) Chapter 6

policy that governs the directors' decision making, has been set out by an external source. This can bear a conceptual significance to the present discussion despite the question of legality. Indeed, the following examples used here outline the overlaps between the standard of duty of care set by the law and the companies' internal policy set up by the companies in compliance with the law.

One of the conceptual examples of this would be the predefined and pre-set health and safety regulations at workplace.

The Health and Safety Executive paper published in June 2013 has laid out the guideline for company directors to adopt, ensuring health and safety of the company's employees at work. The paper also gives examples explaining the consequence of company directors who had failed to effectively follow the pre-determined health and safety guideline. For instance, 'The managing director of a manufacturing company with around 100 workers was sentenced to 12 months' imprisonment for manslaughter following the death of an employee who became caught in unguarded machinery.'[795]

The investigation revealed that, had the company adequately maintained guarding around a conveyor, the death would have been avoided. The judge said that

[795] The Health and Safety Executive 'Case Studies When Leadership Falls Short' (2013) < http://www.hse.gov.uk/leadership/casestudies-failures.htm> accessed 2015

'whether the managing director was aware of the situation was not the issue; he should have known as this was a long-standing problem …'.[796]

Another example relating to the health and safety regulations for directors to be found negligent for their failure to properly implement a required programmed business decision would be matters relating to the removal of or management of asbestos from the work place. Thus, placing the company's employees to the serious health risk asbestos related disease such as lung cancer, mesothelioma and asbestosis. Asbestos is defined by the Control of Asbestos Regulations 2002 to include the minerals such as chrysotile, asbestos tremolite or any mixture of these minerals.

The following provisions published by the Health and Safety executives re-stress that ignorance is not a defense in asbestos issues:

> Recent case law has confirmed that directors cannot avoid a charge of neglect … by arranging their organization's business so as to leave them ignorant of circumstances which would trigger their obligation to address health and safety breaches.[797]

This position corresponds to the health and safety issue discussed above. Both are confirming that programmed business decision can often be made directly and

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[796] The Health and Safety Executive 'Case Studies When Leadership Falls Short' (2013) < http://www.hse.gov.uk/leadership/casestudies-failures.htm> accessed 2015

[797] INDG417(rev 1.) published by the Health and Safety Executive, 16, 8, 06/13. See also, Control of Asbestos Regulations 2012.

indirectly by the directors, rather than being exclusive to lower ranking company officers.

As opposed to Griffin and Moorhead's argument suggesting that programmed business decision yields a small impact on the company,[798] the programmed business decision relating to asbestos management and removal can yield a significant impact on the company. Particularly when the building concerned represents one of the properties within the company's commercial property portfolio in a large scale. Therefore, the removal or management of asbestos can be extremely costly to the company.[799] And any failure of compliance with the relevant Health and Safety Regulations can result the company in facing a significant fine from the relevant public authority.[800]

An immediate example similar to the above health and safety at work regulations and the 2014 Taiwanese food scandal case examples, from a programmed business decision perspective, would be r*e Baring plc (No. 5).*[801] With reference to *Daniels v. Anderson*[802] by Jonathan Parker J (a case already discussed in Chapter Two) who held

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[798] See Ricky W. Griffin & Gregory Moorhead, *Organizational Behaviour: Managing People and Organizations* (South-Western College Pub 2010) 192

[799] JS Moskowitz, *Environmental Liability and Real Property Transaction: Law and Practice* (John Wiley & Sons 1989) 27; see also USA Today, 'When Removing Asbestos Made No Sense' < https://www.nofluoride.com/asbestos.cfm> accessed March 2018

[800] Health and Safety Executive, 'Penalties' <http://www.hse.gov.uk/enforce/enforcementguide/court/sentencing-penalties.htm> accessed March 2018

[801] [2000] BCLC 532 (Ch)

[802] [1995] 16 A.S.C.R. 607, 666 as cited by Reed, 'Company Directors – Collective or Functional Responsibility' (2006) Com Law 173

the company directors negligent due to their failure to implement a programmed business decision relating to the matter of the company's internal control procedure, i.e., a breach of director's functional responsibility relating to supervision over the affairs of the company as required by the law. Similarly, the in the Australian *ASIC v. Rich* the judge held that company directors' duty to monitor the company's business did not constitute business judgment/Non-Programmed (Creative) Business Decisions, rather, such a decision was a programmed business decision due to the certainty element without the question of a 'decision to take or not to take'.[803]

The final examples of a typical programmed business decision made by directors with significant impact on company's interest can be seen in *Dorchester Finance Co Ltd v. Stebbing,* where the directors of a lending company granted a loan without complying with the predefined safety requirements under the Moneylenders Acts and resulted in the loan being turned into a bad debt.[804]

To sum up, contrary to the academic views of the writers such as Griffin and Moorhead, proposing that programmed business decisions are mostly made by lower ranking officers, the business decisions in the Taiwanese food scandal cases in 2014; the health and safety regulations; *re Baring plc (No. 5); and Dorchester Finance Co*

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[803] [2009] NSWSC 1229 [7278] as cited by Keay A & Loughrey J, 'The Concept of Business Judgment' Legal Studies 1 < https://www.cambridge.org/core/services/aop-cambridge-core/content/view/DFC0700879FEF7FF4BD7E9A589A211C4/S0261387518000296a.pdf/concept_of_business_judgment.pdf> accessed 5 January 2019

[804] [1989] BCLC 498 (Ch) as cited by Charles Wild and Stuard Weistein in *Smith and Keenan's Company Law*, (15th edn, Longman 2011) 409

Ltd v. Stebbing mentioned above are all examples of programmed decisions made by company directors with substantial impact to the company's business. These examples clearly and conceptually demonstrate that higher level of management in the organizations such as board of directors are deemed by the courts to owe a duty of care to effectively lead, monitor and make sure that a pre-existing policy of the company, government policy or legal requirement are properly implemented. Failure to properly implement such programmed business decisions would yield a significantly negative impact on company's business, third parties' welfare and even on directors' personal assets.

SUMMARY

H. A. Simon's theory of programmed and non-programmed business decision can be summarized as follows:

A Programmed business decision is a business decision that has been pre-programmed whereby the decision maker, in the process of making the decision, was bound by a predefined rule or policy of which the business decision has to be made from within. This type of business decision, from a legal perspective, coincides with company directors' decisions relating to day to day running of the business; and is ruled by an existing policy, e.g., health and safety requirement or the constitution of the company - binding the director regarding the way in which the business decisions are to be made. As seen from Chapter Two, programmed

business decisions are decisions that do not qualify directors from the protection of judicial or legislated deference, e.g., *Equitable Life Assurance Society v. Bowley*.[805]

A non-programmed business decision is a business decision whereby a decision maker in his decision making-process is not bound to follow any predefined rule in order to reach the decision. In this way, a non-programmed decision reflects the condition of 'novelty' within the definition of creativity.

The objective of this research is to examine the company law's deference in the context of company directors' business decisions. Whereby company directors are required to make the business decision in the interest of the company. The theory of non-programmed business decision itself cannot, however, sufficiently achieve this objective as the concept does not strictly require the component of 'good faith'. To overcome this shortage, I have proposed to combine the psychology theory of creativity from Chapter Four. The end result is a decision model known as Non-programmed (Creative) Business decision, i.e., a type of business decision whereby 1. the decision maker is not bound by a predefined rule in his decision-making process to reach the decision; and 2. the decision has to be made in such a fashion that satisfies the 'usefulness' condition within the definition of the Product Oriented Approach of Creativity. In other words, a Non-Programmed

[805] [2003] 1 Ch 407 (QB)

(Creative) Business Decision within the context of company directors' business decision is a decision that has to be made in the interest of the company.

FURTHER EXPLORATIONS OF THE CONCEPT OF TYPES OF BUSINESS DECISIONS

In the above, I have discussed the differences between Non-programmed and programmed business decisions with the former being processed based on unique and ill-defined information as opposed to well-structured rules relating to the latter.

In the following part of this chapter, I will point out that H.A. Simon's strict compliance of the distinctions between programmed and non-programmed business decisions can be over-simplistic and are based on a number of faulty assumptions. I will demonstrate my related thoughts analytically in the following sub-sections:

EVOLUTIONS OF TYPES OF BUSINESS DECISIONS & SEPARATION OF BUSINESS DECISIONS FROM A BUSINESS DECISION

In this section, I would, at the first stage of my discussion, borrow an existing theory of semi-programmed decision coupled with my proposed terminology, i.e., 'Evolution of Types of Business Decisions' to demonstrate the faulty assumptions of strict compliance of the models of programmed and non-programmed business decisions. Once this is done, the second stage will set in, whereby I will apply my own analysis to show that certain types of programmed decisions or semi-programmed decisions in business context can be viewed as non-programmed business decisions due to certain 'external' factors.

In reality, many often there can be an overlap between types of business decisions with the consequence of having a specific type of decision that ‘evolves’ into another type. For instance, take the smartphone scenario quoted in the earlier part of this chapter; assuming that a smartphone manufacturer A made a non-programmed decision last year to introduce and release the world’s first smartphones. As a result, the manufacturer enjoyed a great commercial success over the sale of the products for one financial year.

This year, the directors of the manufacturing company A decide to continue the production line and release further smartphones into the same market. At this point, it can be argued that the business decision which was originally non-programmed is now turning or ‘evolving’ into a programmed business decision due to the loss of its uniqueness and innovativeness through its reccurrence. Besides, many of the pre-set rules in regards to the implementation of the recurring business decision would, by this time, have been established by way of the manual instructions or the computer system. This existence of a predefined rule is a typical component of a programmed business decision.

For clarity, please note that it has occurred to me that the above process has been ’indirectly recognized’ by H.A. Simon himself as well as other academic writers such as Cyert and Throw in the process of stating that a person might not be able to use a predefined programme to meet the solution of another problem which is non-programmed:

> If the rule determined when action would switch from one programme steps to another were specified, and if the programme steps were described in enough detail, it would be possible to replicate the decision process. The programmed steps taken together defined in retrospect, then, a programme for an originally un-programmed decision. The program would be inefficient one because it would contain all the false starts and blind alleys of the original process … [806]

To further elaborate my smartphone business decision scenario presented earlier on, by linking to the above statement which concluded that uniqueness (creativity or innovation) contain an element of 'blind alleys of the original process'.[807] And therefore, the smartphone business decision in question has to be 'original' or 'novel' by way of uniqueness and innovation in order to be taken as a non-programmed business decision. This is in line with the definition of Product-Oriented Measure of Creativity Theory explored in Chapter Four. Namely, 'novelty' plus 'usefulness'. Only when there is a recurrence of the business decision in the same circumstances, will it be a programmed business decision.

To better understand the subject, one has to realized that the recurring smartphone business decision (now a programmed business decision) still carries certain components of which the business decision 'inherits' from its original form, i.e., a non-programmed business decision; hence an overlap between the two types of

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[806] Cyert et al, 'Observation of a Business Decision' (1956) J BUS 245
[807] ibid

business decisions occurs. As already illustrated in the earlier part of this chapter, the non-programmed business decision in this case include:

- Long-term impact on the company A's success (to attract more buyers with the aim to prevent losing its existing customers); and

- Such a decision still requires the involvement of a high-level executive judgment taken at the board level.

Despite the overlap, a person at this stage can still be able to identify a 'pure' non-programmed business decision within a programmed business decision, if say, the smartphones being released this year contains a unique and innovative feature. For instance, in competing with the competitors' products, company A's smartphone is now exclusively waterproof and presented with a new smartphone shape style. Consequently, the revolutionized in-built waterproof function in the smartphones, as well as, new shape style will be a non-programmed decision[808] due to the ill-defined information on which the company is to undertake the project. To sum up, the decision to continue the production line of the smartphones is a programmed decision, as at this stage is it based on an existing production method and business strategy; and the additional water-proof and the new shape features to be added to the smartphone constitutes a non-programmed business decision.

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[808] See Samsung Electronics (UK) Limited v Apple Inc. [2012] EWHC (Ch) on the shape style of Samsung smartphone as mentioned in Chapter Four case studies number one.

As demonstrated above, the evolution of types of decisions or as traditionally known, a semi-programmed decision[809] as described by Gupta, 'In this type of decision at least one or more than two of the stages can be handled by a well-defined pre-set procedure.' Similarly, from the legal perspective, when assessing a business decision, judges would take the approach to view 'the decisions within a decision' independently and separately to enable them to clearly identify whether or not judicial or legislated deference can be applied. For instance, in *Iesini v. Westrip Holdings Ltd*[810] where the judge in deciding whether or not to allow the continuing of the action, identified (within the decision to continue the derivative claim) a distinction between programmed decision (evaluating and selecting option on whether or not to pursue a derivative claim based on success rate of the case, the legal cost plus the amount of compensation to be obtained) and non-programmed decision (evaluating and selecting option on whether or not to pursue a derivative claim, in an attempt to prevent any disruption to the Company's business)[811] leading to the conclusion that the court is ill-equipped to handle the latter.

COMPANY DIRECTOR POSSESSING PROFESSIONAL SKILLS

Following the above discussion, now take a look at the separation of programmed business decision from a non-programmed business decision from another perspective. A director who makes a business decision through the reliance of his professional skill, for instance, a director acting as a property surveyor who manage the company through the relevant skills. In this situation, the director will be

[809] As described by Hitesh Gupta, 'In this type of decision at least one or more than two of the stages can be handled by a well-defined pre-set procedure.' Hitesh Gupta, *Information Management System*, (International Book House PVT. Ltd, 2007) 88

[810] [2009] EWHC 2526 (Ch) [80]

[811] See paragraph 2.7 above for definition of a business decision.

deemed to have made a programmed business decision even though such a decision forms part of a larger decision that is non-programmed.

This is so because the business decision is based on the professional expertise of the director. And such a professional expertise is governed by a pre-existing code of conduct of which the business decision is based upon.

For instance, in *Norman v. Theodore Goddard* [812] the court differentiated the director's skills in property management (programmed decision) and duty to seek advice from Corporate Trust Lawyers (again, programmed decision) from the overall offshore tax advance project involving elements of uncertainty and ill-define information to the director (non-programmed decision).

THE SOCIETY DETERMINES THE TYPES OF BUSINESS DECISIONS (COMPANY SHARE RE-PURCHASE SCHEME EXAMPLE)

Apart from the situations where a non-programmed decision evolves into a programmed business decision or an overlap between the two types of business decisions, we can also observe another pattern where the types of business decisions are actually shaped by 'a form of human freedom (as described in Chapter Four regarding Creativity)[813] which operates in the same fashion as the condition of

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[812] [1991] BCLC 1028 (Ch)

[813] J. Maitland, 'Creativity' (1976) J Aesthet Art Crit Vol 34 No 4 397, 408; Kristina Jaskyte and Audrone Kisieline, 'Determinants of Employee Creativity: A Survey of Lithuanian Non-Profit Organisations' (2006) VOLUNTAS vol 17 No 2 133, 139; see also T. Amabile and J. Giltomer, 'Children's Artistic Creativity: Effects of Choice in Task Materials' (1984) Unpublished Manuscript, Bradies University (as cited by Beth A. Hennessey, 'Social, Environmental, and Developmental Issues and Creativity' (1995) Edu Psychol Rev Vol 7 No. 2 163, 168)

Novelty within the theory of creativity, i.e., novelty is not about literal newness but a decision that is free from the governing of any predefined regulations.

To elaborate this, I now would like to borrow M.A. Boden's theory that describes the society being the factor in determining whether or not a product is unique[814] (or 'non-programmed' for the purpose of the present discussion). Let's say that directors of Company have made a business decision to undertake a share re-purchase scheme through the open market approach.

The share re-purchase project will be a non-programmed decision due to its uniqueness and innovativeness. Such a view can be taken from the theoretical perspective where such a business decision was made to allow the company to adapt to any significant change of any 'external' circumstances, market taste or 'the society' (a term used by M.A. Boden as quoted above). 'The change of the society' could refer to a change in the economic, commercial, social or scientific condition surrounding the share re-purchase project.

A typical stock operating situation, a predicted temporally decrease of the general level of consumer's spending or a temporally change of consumers' fashion taste in relation to company's products causing the company's temporally inability to reinvest its retained profit. Thus, led to an undervalue of its own shares. The share buyback

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[814] See generally M. Boden, *The Creative Minds: Myths and Mechanisms* (2nd edn, London Rutledge 2003)

would then be desirable to reduce the outstanding shares in order to ensure an increase of the earning per share. And then, when the directors' business forecasts indicate that the market will shortly correct itself, the re-issuance of those shares will eventually lead to an increase of the company's equity capital.[815] These changes of the business environment or 'the society' has shifted the focus on the 'problem' on which the decision was made to resolve. This effectively renders the share re-purchase project ill-defined.

Using Product-Oriented Measure of Creativity Theory to assess the above, we can see that the change of the 'society' (of which the business project or idea is corresponded to) represents the novelty; and provided that the business decision also satisfies the condition of 'usefulness', the business decision will be classified as a Non-Programmed (Creative) Business Decision, i.e., a specific type of non-programmed business decision that has exclusively been made in the interest of the company.

Indeed, as Amabile has said about the interrelationship between a decision and the external factor within the context of Product-Oriented Measure of Creativity that:

> If we take individual ideas or product that can be reliably identified as creative by experts, then we can look at … the environmental factors … corresponding

[815] For reasons associated with share buyback, see Shares Magazine, 'Why Do Companies Buy Back Shares' (23rd November 2017) <https://www.sharesmagazine.co.uk/article/why-do-companies-buy-back-shares > accessed 3rd May 2018.

> to the production to those ideas or products. Thus, the definition used here is based on products (ideas): creativity is the production of novelty and useful ideas by an individual or small group of individuals working together.[816]

It follows that, it would be correct to say that the condition in determining the element of uniqueness and innovation of a business decision can be speculative. It can also be correct to say that the condition in determining the element of uniqueness and innovation of a business decision can be determined by the external factors. And with reference to the above paragraph, a significant change of commercial or social environment to which the business decision is corresponded to. The uniqueness of the decision caused by the external factors relating to the business environment renders the decision non-programmed. Indeed, the nature of non-programmed decisions as described by Venkatachalam and Sellappan is to allow 'the organization to change and adapt to its environment'.[817]

This interpretation of non-programmed business decisions is very much in line with the legal understanding of business judgment within the operation of judicial deference or section 263(3)(b) of the Companies Act 2006. As discussed in Chapter Two, business judgment is a non-programmed nature which is not subject to any predefined rule (for instance, where the judge in *Overend Gurney & Co v. Gibb* took

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[816] Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisation' (1988) Res Organ Behav vol 10, 125- 126 (1988)

[817] Venkatachalam and Sellappan, *Business Process* (Prentice-Hall of India Pvt. Ltd 2011) 115

into account of the change of the 'the society' or the 'mercantile world'[818] when describing a non-programmed business decision as a '…conduct ... a great deal of more speculation … and a great deal more readiness to confide in the probabilities of things…';[819] or *Iesini v. Westrip Holdings Ltd*[820]*; and Kleanthous v. Paphitis*[821] where the judge in considering section 263(3)(b), expressed a general deferential principle on the list of non-exhaustive commercial factors (exclusively emphasizing directors' business decisions that are not subject to any predefined policy) as opposed to company director's functional responsibilities which is of programmed nature, for instance, director's duty of internal control management and corporate oversight as shown in the case of *re Baring plc and others (No. 5), Secretary of State for Trade and Industry v. Baker*.[822]

SUMMARY

Company directors making business decisions day in and day out, many of the decisions by nature cannot be simply categorized into one single type as they are of mixed types in nature. As a result, judges have shown the tendency to identify the types of business decisions within the embodiment of one decision. For instance, a hypothetical director's decision to continue a legal action against the company under sections 263(2)(a) and 263(3)(b) Companies Act 2006 has been broken down by the

[818] LR 5 (HL) 480, 495
[819] ibid 480, 495
[820] [2009] BCC 420 (Ch) [85]
[821] [2011) EWHC 2287 (Ch) [71], [72]
[822] [1999] 1 BCLC 433 (Ch)

judge into different types of decisions for the purpose of deciding whether or not such a decision to continue the action is permissible. In other words, a programmed decision which can be assessed by the judge against a predefined rule or calculation, such as the amount of financial compensation. And a non-programmed decision of which the judge is ill-equipped to assess due to absence of any predefined rule, for instance, any disruption to the company' board of directors' dynamics as a consequence to the continuation of the legal action (*Iesini v. Westrip Holdings Ltd;*[823] *and Wishart v Castlecroft Securities Ltd*[824]).

Judges in cases such as *Dodge v. Ford Motor Vehicle*[825]; and *Overene Guerney & Co v. Gibb*[826] have also shown the tendency to appreciate that the element of uncertainty or speculation in a 'mercantile world'[827] (that results in the absence of any predefined rule) is very broad. Such element of uncertainty or speculation can be identified not just the business decision itself, but also by way of external factors such as the change of business environment and the consumer's fashion taste which renders a predefined rule obsolete. Thus, turning what was originally a programmed business decision into a non-programmed business decision.

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[823] [2009] BCC 420 (Ch)
[824] [2010] CSIH 2 (CSIH)
[825] [1909] N.W. 668, 684
[826] LR 5 (HL) 480, 495
[827] ibid

In the above, I have discussed the types of business decisions leading to the conclusion of a fusion of non-programmed business decision with Product-Oriented Measure of Creativity definition. This is known as Non-Programmed (Creative) Business Decisions. In the following, I shall look into the types of business decisions and judicial/legislated deference, from a relevant psychology perspective, by way of case studies.

Case studies method is defined by Thomas as follows:

> Case studies are analysis of persons, events, decisions, periods, projects, policies, institutions, or other systems that are studied holistically by one or more methods. The case that is the subject of inquiry will be an instance of a class of phenomena that provides an analytical frame – an object- within which the study is conducted and which the case illuminates and explicates.'[828]

To further elaborate the concept of types of business decisions within the definition of the Product Oriented Approach in Creativity,[829] and how both of programmed &

[828] Thomas G (2011) *'Sonia is typing...A typology for the case study in social science following a review of definition, discourse and structure'* Qualitative Inquiry 17 (6): 511–521 as cited in https://en.wikipedia.org/wiki/Case_study.

[829] The proposed concept of Non-programmed (Creative) Business Decisions consist the elements of Product Oriented Measure of Creativity and Non-programmed Types of Decisions, thus it is necessary to cover both in these case studies.

non-programmed types can render judicial or legislated deference inoperable by the element of bad faith, I shall use a number of actual law cases.

Each of these cases is randomly chosen within a population of cases where their contextual conditions are of direct relevance to the application of the concept of types of business decisions. As the chosen cases are law cases with the relevant outcomes being determined by the judges, the writer of this thesis had no control over the outcome of these cases. The chosen cases are used to test the concept of types of business decisions presented in this thesis. In terms of the direct relevance, first, the cases have been selected on the basis that they are of the U.S and the UK cases. Together they serve as an analytical framework suitable for the jurisdictional background of this thesis. Second, they are chosen with an aim to demonstrate the concept from contrasting perspectives. For instance, *Franbar Holdings Ltd V. Patel;*[830] *Kleanthous v. Paphitis*[831]; and *Bhullar v. Bhullar*[832] are respectively selected to examine programmed business decisions; Non-Programmed (Creative) Business Decisions; and decisions that have not been made in good faith with the framework of derivative claims under the Companies Act 2006. Whereas cases such as *Smith v. Van Gorkom*[833] and *Re. Walt Disney Company Derivative Litigation (Disney V)* [834] are selected to look into the concepts from the perspective of judicial

[830] [2009] Bus LR D14 (Ch)
[831] [2011] EWHC 2287 Ch)
[832] [2016] BCC 134 (Ch)
[833] [Del. 1985] 488 A.2d 858
[834] 907 A 2d 693 [2005]

deference or business judgment rule which, unlike legislated deference, do not operate within the statutory framework.

It should be noted that the case studies exercises are in no way aimed to decide the liability of the directors. They are only used to give indications as to how the court determined or should determine, from a psychology (and management) perspective, the type of business decisions. It should also be noted that the concept of types of business decisions based on creativity is a concept with high flexibility. Thus, the assessment of the types of business decisions is highly dependent on the facts of each case. An appropriate degree of assumptions will be given to demonstrate the flexibility of the concept.

To achieve a better understanding of this research, I shall first summarily recap the basics of the proposed concept of a Non-programmed (Creative) Business Decision. A Non-programmed (Creative) business decision is based on the three main premises (together hereby known as the **Rule Number One**) as already discussed in the early part of this chapter as well as Chapter Four, namely:

- that the business decision must carry an element of ‘novelty’ or ‘originality’. Such element can be derived from a pure originality by its own or a change of the people’s perception, i.e., the ’environment’ or ‘society’ that relates to the business decision. In other words, there must either be a none- existence of a predefined rules governing the way in which the business decision should be made or conducted; or that the

relevant predefined rule becomes ill-defined or obsolete as a result of a change of the 'business environment'[835];

- that the business decision must be 'useful' to the company, in other words, the business decision must have been made bona fide with an aim to benefit the company. Therefore, 'the right and wrong in the quality of the business judgment'[836] is not relevant.[837] This, in effect, renders the principle of immediate shareholders' profit maximization (or to a certain extent, short-termism) laid down by the judge in the case of *Dodge v. Ford Motor Co*[838] irrelevant[839] in deciding whether or not the decision constitutes a non-programmed (Creative) Business Decision; and

- that the directors' misconduct with reference to gross negligence, bad faith and conflict of interests precludes creativity. This condition is in line with the principles of both American business judgment rule, as well as, the UK legislated judicial deference as discussed in Chapter Two.

PROGRAMMED BUSINESS DECISIONS CASE STUDIES

CASE STUDY 1: *FRANBAR HOLDINGS LTD V. PATEL* [2009] BUS. L.R. D14 (CH)

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[835] See also Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisation' (1998) Res Organ Behav Vol. 10, 125-126

[836] As per Lord Wilberforce in the case of *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] UKPC 3 (PC) 832, the court has 'no jurisdiction to determine the right and wrong of the quality of a business judgment'. In other words, the court is only to decide if the business decision had been made in good faith in the interest of the company; and if the decision is a business judgment or as this thesis puts it – a Non-Programmed (Creative) Business Decision.

[837] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] UKPC 3 (PC) 832; See Teresa M. Amabile, 'A Model of Creativity and Innovation in Organisation' (1988) Res organ Behav, Vol 10, 125 – 126

[838] [Mich 1919] 170 NW 668, 684

[839] *Shlensky v Wrigley* 237 M.E. 2d 776 [lll. App. 1968]

Facts: Franbar (the Claimant) had sold over 75% of shares of Medicentres (Company M) to Casualty Plus (Respondent 1). In addition, the Claimant had entered into a shareholders' agreement with Respondent 1 allowing each of the parties to sell or call the shares of Company M at a price 9 times higher than Company M's earnings. Casualty Plus appointed two directors (the Respondent 2). A derivative action brought by the Claimant, the minority shareholder, on behalf of Company M against both Respondents 1 and 2.

An application to continue the action under section 263(2)(a) was refused by the court on the ground that Company M was in the course of pursuing its own remedy, i.e., under the existing shareholders' agreement for breach of the covenants by the Respondents. Company M would, therefore, incur an additional legal cost should the hypothetical director decides to pursue the continuation of the derivative action against the respondents (in view of the duty to 'promote the success of the company' owed by a hypothetical director within the provisions of section 172).

Comment: the hypothetical director decision to discontinue the derivative action against the Respondents constitutes a programmed decision as it was made based on the assessment of both of the predefined legal cost and compensation obtainable in the derivative action (pursuing in combination with the shareholders' agreement action) against the legal cost and compensation obtainable through the shareholders' agreement action alone.

CASE STUDY 2: *SMITH V. VAN GORKOM* (ALSO KNOWN AS TRANS UNION CASE) 488 A.2D 858 [DEL. 1985]

Facts: there was a leveraged buyout merger of TransUnion proposed by another company known as Marmon Group. A leveraged buyout is a mechanism employed to take over a company with the funds that are mostly or entirely acquired from debt.[840] During the price negotiation stage with the bidder - Marmon Group, Mr. Van Gorkom – the TransUnion chairman and CEO, casually set the company's proposed price per share at a sum of fifty-five dollars without any consultation from an external share price expert.

The proposed share price of Fifty-Five Dollars was subsequently put forward to TransUnions' Board of directors for their approval. However, no relevant information regarding the methodology and calculation on how Mr. Van Gorkam arrived at the proposed Fifty-Five Dollars figure was asked to be disclosed in the board meeting. In addition, the fact that the proposed figure was not agreed by the company's management was completely ignored in the meeting. Without following the usual standard based on the required information, the board swiftly approved Mr. Van Gorkom's proposed share price.

When the case was brought before the court, the judge was highly critical of Mr. Van Gorkam's share price decision. Stating that 'the record is devoid of a competent

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[840] See generally, Burrough & Heylar, Barbarians at the Gate, *New York: Harper and Row* (Arrow 1990) 113-116

evidence that fifty-five dollars represented the per share intrinsic value of the Company'[841] and ruled that both Mr. Van Gorkom and the board of directors liable for negligence.

Comment: When applying the Rule Number One, it is clear that the business decision made by Mr. Van Gorkam was a programmed business decision as there was no element of novelty or originality that related to the proposed share price figure. In other words, there was a predefined rule in the context of the methodology relating to the calculation commonly applied to the share price of the company subject to a proposed leverage buyout.

It was also clear that the approval of the board of directors in favour of Mr. Van Gorkom's proposed figure was too, a programmed business decision, as the steps of approving the proposed share price had been predefined under the company's constitution. In other words, it was part of the directors' functional responsibility to supervise Mr. Van Gorkam to ensure that the proposed figure had been properly reached.[842] These included the requirement of seeking the disclosure of the

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[841] As cited by David Kershaw, *Company Law in Context – Text and Materials* (2nd Edn, OUP Oxford 2012) 414; Also as cited by Lynn A. Stout, 'In Praise of Procedure: An Economic and Behavioural Defense of Smith v. Van Gorkam and the Business Judgment Rule' (2002) 96 NW U L REV 675; and See also further information on *Smith v Van Gorkom* 488 A.2d 858 [Del. 1985] as cited by Herbert S. Wander & Alain G. LeCoque, 'Boardroom Jitters: Corporate Control Transactions and Today's Business judgment Rule' (1986) Bus Law Vol 42, 64

[842] This approach of differentiating between directors' business judgment and functional responsibility with the latter being excluded from the protection of judicial deference is in line with the British judicial approach in cases such as *Re Barings plc* [1999] BCLC 433 (Ch); and *Equitable Life Assurance Society v Bowley* [2003] 1 Ch 407 (QB) as already discussed in Chapter Two.

methodology in arriving the fifty-five dollars per share price, as well as, offering the reasons of objecting the proposed price by the company management.

During the process of the litigation, the court noted that the defendant directors were experts of leveraged buyout. This serves as strong evidence that the board was accustomed to follow the predefined rule in establishing whether or not the share price was reached in accordance with the proper methodology but had failed to do so.

CASE STUDY 3: *RE D'JAN OF LONDON LTD* [1994] 1 BCLC 561 (CH)

Facts: Mr. D'Jan, the director of the company, signed an insurance form containing an amendment to the insurance terms on behalf of the company without at all reading it. It later transpired that the revised insurance policy had been filed mistakenly by the company's insurance broker because the proposed insurance term contained a mistake, i.e., a negative answer was given to the question asking if Mr. D'Jan had been a director of any company that had been liquidated.

The consequence of this error resulted in the insurance company vitiating the insurance. Thereby forfeiting the insurance proceeds covering the substantial value of the stocks that were later destroyed by the fire at the company's premises. Consequently, an action of negligence was brought against Mr. D'Jan.

Comment: Irrespective whether or not the insurance form was signed with an intention to benefit the company (thus satisfies the second condition of the Product-Oriented Measure of Creativity) the director's act of signing an insurance

form was still a programmed business decision as the insurance form would contain a warning notice requesting the authorized signatory to read and answer the questions carefully to avoid the insurance being vitiated. This warning notice serves as a predefined rule to be followed by the director to ensure the validity of the insurance policy.

NON-PROGRAMMED (CREATIVE) BUSINESS DECISION CASE STUDIES

CASE STUDY 1: *KLEANTHOUS V. PAPHITIS* [2011] EWHC 2287 (CH)

Facts: The claimant, a shareholder of the company sought the permission from the court under Section 261 of the Companies Act 2006 for the continuation of the derivative action against the director. To decide on whether or not to allow the derivative action to continue, the court was to decide on whether or not a hypothetical director would make a commercial (or non-commercial) decision that the discontinuation of the action was in the interest of the company within the provision of section 172 Companies Act 2006.[843]

The permission to continue the derivative action was refused on the basis that the court was diffident to second guess the commercial factors[844] proposed by the defendant directors. Namely, the company would be adversely affected by the

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[843] *Kleanthous v. Paphitis* [2011] EWHC 2287 (Ch) [70]

[844] In giving the judgment, the court concluded that the directors are in better position than the court in 'assessing where the companies' commercial interest lie' *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch) [75]. This is very much in line with Lewison J's statement in *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch) [80] who refused to second guess the commercial judgment of company directors on the basis that 'the court is ill-equipped to take'.

litigation on the director's business decisions by way of disruption to the company employees' morale as a whole. This included the morale of the senior management. It was also claimed that the decision to continue the derivative claim would result in 1. losing company directors which in turn, would damage the company's future trade performance; and 2. damage to the company's reputation 'as a result of publicity and disclosure arising from the litigation'.[845] All these speculations had 'much force'[846] in judges' mind with the consequential result in the discontinuing of the derivative action. Based on the absence of evidence to the contrary, the court was satisfied that these commercial factors had been proposed, in good faith, by the director within section 172 Companies Act 2006.

It should be noted that other than the general commercial factors, the court's refusal to continue the derivative action was also made on the basis of a hypothetical director's programmed decision relating to weighing the size and strength of the claim against the benefits to the company in granting the permission; the availability of alternative redress; and the directors' financial 'contributions' to be used to compensate the loss. These are the matters of programmed decision which was dealt with in Case Study One of Programmed Business Decisions of this chapter; and shall be disregarded for

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[845] *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch) [71], [72] & [73]; also mentioned in Kershaw, Company Law in Context: Text and materials (2nd edn, OUP Oxford, 28 Jun. 2012) 613

[846] ibid; also as cited by Kershaw, Company Law in Context: Text and Materials (2nd edn, OUP Oxford, 28 Jun. 2012) 622

the purpose of the discussion of Non-programmed (Creative) Business Decision in this section.

Comment: In the absence of strong evidence to the contrary from the claimant[847] (this would mean that the hypothetical director's business decision to discontinue the action was not made with gross negligence. Thus, the principle of a Non-Programmed (Creative) Business Decision can now apply), the hypothetical director's business decision (taking into account of the business factors, including the disruption of the company's senior management, the damage to the company's reputation; and the damage to the trade relationship between the company and its customers) in not pursuing the continuation of the derivative claim is a Non-Programmed (Creative) Business Decision. As 1). the court admitted that there was no predefined rule that enables the court to accurately assess those business factors; and 2). that the hypothetical director's business decision satisfies the condition of 'usefulness' within the definition of the Product-Oriented Measure of Creativity, i.e., the business decision was made in good faith with an aim to benefit the company. In other words, the business decision 'would be most likely to promote the success of the company …' within the provisions of s172. This is so because the business factors such as retaining the talented directors; keeping the positive image of the company's reputation; and maintaining the proper trade relationship with its customers and creditors are business

[847] *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch) [73]

factors that cannot be excluded or minimized in the interest of the company and its shareholders.

CASE STUDY 2: *RE. WALT DISNEY COMPANY DERIVATIVE LITIGATION (DISNEY V)* 907 A 2D 693 [2005]

Facts: Michael Ovitz, a founder of Creative Artists Agency (CAA) and one of the most powerful figures in Hollywood, was hired under a five-year contract to serve as the president of the Walt Disney Corporation in 1995. Unfortunately, his presidency was not a successful one. Thus, the presidency contract between Mr. Ovitz and the company was terminated just over one year of Mr. Ovitz' office.

Mr. Ovitz soon filed a claim against the company for a severance payment of one hundred and thirty million US dollars under the presidency contract package even though Mr. Ovitz had only performed his part of the contract for merely one year. It should be noted that the severance payment provision was made in favour of Mr. Ovitz with the exceptions of gross negligence, fraud or dishonesty. The presidency contract was terminated for the reasons not falling within any of these exceptions.

The company shareholders were not happy about the original deal and brought a derivative action against the company's directors who were responsible for incorporating the severance payment provisions into the presidency contract.

In an attempt to preclude the directors from the protection of business judgment rule, the plaintiffs in the case included in their claims relating to both question of lack of

good faith, as well as, directors acting grossly negligent in relation to their decisions to hire Mr. Ovitz' through the entitlement of the severance payment.'[848]

The court held that the directors were sufficiently informed of the facts when hiring Mr. Ovitz. The directors, therefore, were not grossly negligent; and were acting, in good faith, in the interest of the company to have the severance payment clause added to the director's contract as an inducement to successfully recruit Mr. Ovtiz as a new director. The court held that the decision to enter into the presidency contract with Mr. Ovitz constituted a business judgment. Consequently, the directors were protected by the business judgment rule of which the court was ill-equipped to second guess.[849]

Comment: it would not have been difficult to decide whether or not such a business decision was a Non-programmed (Creative) Business Decision (even though the contract resulted in the company in losing over one hundred and thirty million US dollars) if, for instance, Mr. Ovitz had brought with him a new commercial technology and had assigned the same over to the company as a consideration in exchange of the presidency contract. The new technology would have benefited the company despite the severance payment.

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[848] Derivative Litig. Disney V [2005] 907 A.2d at 749 as cited by Andrew S. Gold, A Decision Theory Approach to the Business Judgment Rule: A Reflection on Disney, Good Faith, and Judicial Uncertainty' (2007) Md L Rev, vol 22, 398 , 406; See also generally William A. Klein, *Business Associations* (8th edn, Foundation Press 2012) 368

[849] [2005] 907 A 2d 693, 747 and 760

In reality, the usefulness for hiring Mr. Ovitz (at the expense of the high salary package and the risk of incurring the substantial severance payment) was derived mainly from a desirable demand for his powerful connection within Hollywood which offered the company a greater opportunity in the business of the film making industries. As Irwin Russell, one of the company's director subsequently commented that 'Ovitz was an exceptional corporate executive… who merited "downside protection" and "upside opportunity"'.[850] In other words, in an attempt to gain Mr. Ovitz's business brilliance, the severance payment provision as a ''downside protection'' was a business judgment exercised by the directors, in good faith, as an appropriate independent organ of the company.

Other than the business brilliance of Mr. Ovitz, the condition of 'usefulness' of this Non-Programmed (Creative) Business Decision could be established, from another perspective, i.e., by the fact that the severance payment was used as a 'downside protection' with an aim to persuade Mr. Ovitz to give up his Fifty-Five percent shares in his old company – CAA, thereby, ensuring his business loyalty to Walt Disney.[851]

The novelty of the business decision can be traced from the inclusion of the severance payment provision into the directorship contract as an incentive or enticement to achieve the recruitment of Mr. Ovitz. As there was no any predefined rule governing

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[850] Derivative Litig. (Disney V) [2005] 907 A.2d 27 at 36-37 as cited by Andrew S. Gold 'A Decision Theory Approach to the Business Judgment Rule: A Reflection on Disney, Good Faith, and Judicial Uncertainty' (2007) Md L Rev Vol 22, 398, 473

[851] [2005] 907 A 2d 693, 702 and 703

the way in which the provisions of the presidency contract had to be negotiated and drafted. Much was depending on the bargaining powers of the parties and how they achieved a common goal by 'solution design'. In other words, the severance payment provisions were 'designed' as an extraordinary clause to entice Mr. Ovitz who had originally refused to relinquish his fifty-five percent shares in his old company.[852] With the two conditions of 'usefulness' and 'novelty' being satisfied, the act of hiring Mr. Ovitz through the presidency contract containing the severance payment clause was a business judgment in the eyes of the court;[853] and from a psychology perspective – a Non-programmed (Creative) Business Decision.

CASE STUDY 3: *SHLENSKY V. WRIGLEY* 237 M.E. 2D 776 [III. APP. 1968]

Facts: Between 1961-1965, the director of a baseball club known as Chicago Cubs consistently refused to install field lights which prevented the night baseball games to be played at Wrigley Field. The plaintiff shareholder of Chicago Cubs was not happy with the director's business decision, brought a derivative action against the director for negligent mismanagement of the company's business.

The plaintiff shareholder alleged that night baseball was not a new activity as it had been played by twenty major league teams since 1935. And that it had been a continuous practice for the purpose of maximizing the company's revenue and income.

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[852] ibid
[853] ibid

The plaintiff also claimed that the company had suffered a financial loss due to the continuing absence of the night baseball games in Wrigley Field.

During the process of the litigation, the plaintiff, in addition to the above allegations, accused the director of acting in bad faith against the company. This was an attempt to ensure that the director was to be precluded from the protection of the business judgment rule (thus the relevant principles of good faith laid down in cases such as *Davis v. Louisville Gas & Electric Co.*[854]; and *Toebelman v. Missouri-Kansas Pipe Line Co.*[855] were consulted by the judge). The director was subsequently cleared from this accusation[856]; and the director's business decision constituted a business judgment of which the court considered itself to be ill-equipped to interfere with.[857]

Comment: This is a Non-Programmed (Creative) Business Decision subject to the change of environment or 'society'[858] for the following reasons:

- the business decision on refusing to play night baseball games by way of the refusal on the field light installation was tantamount to an element of 'novelty' as there was no predefined rule as to how night baseball games were to be excluded (the assertion was not about whether or not the director had been in compliance with the standard

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[854] 142 A 654, 659 [Del. Ch. 1928] as cited by Mr. Justice Sullivan in *Shlensky v. Wrigley* 95 APP 2d 173, 178 [Ill. App. 1968]

[855] 41 F Supp 334, 339 [1941] as cited by Mr. Justice Sullivan in *Shlensky v. Wrigley* 95 APP 2d 173, 179 [Ill. App. 1968]

[856] [1968] 95 APP 2d 173, 180

[857] [1968] 95 APP 2d 173, 183

[858] As discussed in Paragraph 5.12 above - A term used by M. Boden, *The Creative Minds: Myths and Mechanisms* (2nd edn, London Rutledge 2003)

procedure of installing the night light. Rather, it was about the director using the absence of the night light to exclude night games). Also, the exclusion of night baseball games was, in that particular era or 'environment', a new business approach as night baseball games were a common practice amongst the U.S baseball clubs since 1935;

- the business decision was a business decision that satisfied the second condition, i.e., 'usefulness' as the director made the decision in good faith with an intention to genuinely benefit the company for the following reasons:

a. preservation of the company's reputation: due to the peculiar location of the baseball field, i.e., the baseball filed was at a highly populated residential area where the neighbourhood was extremely vulnerable to loud noises and disturbances. It wasin the best interest of the company's reputation to avoid having the night baseball games;[859]

b. avoidance of unnecessary cost: the neighborhood's objection to the local government's planning permission for the proposed night baseball games would, in any way, have prevented the night games project from going ahead. The chance of success on the local residents' objection could be further enhanced on the ground that their properties value would have been depreciated by the introduction of the night baseball games. Consequently, the company would have suffered from a considerable

[859] [1968] 95 APP 2d 173, 181

financial loss from an attempt to acquire the relevant planning permission; money spent on the equipment and advertising for the night games[860]; and

c. the value of the company's real estate, including the baseball field at Wrigley Field, could also have been substantially and adversely affected as a result of the proposed night baseball games.[861]

It is interesting to note that the plaintiffs' allegation of bad faith on the part of the director was further weakened by the fact that during the litigation, the judge found no evidence whatsoever to support the plaintiff's claim, i.e., that night baseball games played by other baseball teams had any connection with the increase of their profits.[862] On the other end of the spectrum, the strength of the above 'benefits argument' to the company was enhanced by this lack of evidence in support of the argument that nigh baseball games led to great company revenue.

CASE STUDY 4: *HILDRON FINANCE LIMITED V. SUNLEY HOLDINGS LIMITED* [2010] EWHC 1681 (CH)

Facts: In 1986, the directors of the seller company sold a large block of flats and in the contract of sale, there was a provision for the overage payment which provided that a share fifty percent proceeds of sale to be paid to the seller company upon the subsequent sale of the porter's flat. The trigger event of the overage payment was based on the two conditions being satisfied: 1. when the porter's flat was no

[860] ibid
[861] ibid
[862] ibid 173, 182

longer required to accommodate a resident porter; and 2. that the flats was sold in an open market.

The Leasehold Reform Housing and Urban development Act 1993 came into force after the sale. The Act allowed the tenants of the flats to acquire the flats by way of collective enfranchisement rights. When the porter's flat ceased to be occupied by the resident porter, the tenants exercised their right under the new law which prevented the seller company from selling the flats in the open market. Thereby rendered the overage provisions void. The freehold of the porter's flat was transferred to the tenants at a price of twenty thousand pounds, one third lower than that of the price that could have been obtainable in the open market; but fifty percent higher than the original price when the flat was sold in 1986.

The judge ruled the parties in the original property disposal was not in a position to be able to predict the enactment of the 1993 Act.[863] Therefore, there was no element of bad faith on the part of the director of the selling company.

Comment: This is similar to the Disney case in Case Study No. Two as both cases are concerned with contracts secured by the company directors. The seller company's directors could have been liable for negligence for restricting their company's overage in the open market sale, thereby frustrated the overage under the 1993 Act. However, the directors should be insulated from negligence liability. This is because director's

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[863] [2010] EWHC 1681 (Ch) 37

business decision on the overage provisions in the original sale contract was a Non-Programmed (Creative) Business Decision on the grounds that 1. that the novelty of the business decision has been satisfied as there was no predefined rule governing how the overage mechanism was to be formulated. Despite the fact that the director of the seller company decided to maximize the sale proceeds by way of an overage, at a potential risk of non-payment over the seeking for a higher sale price at the outset, it was a matter of business and investment negotiation between the parties. The law that came into force after the sale, was an event that the parties had no chance to predict when the overage agreement was entered into; and 2. that the business decision has satisfied the requirement of 'usefulness' as the overage agreement was constructed to allow the seller company to acquire a share of an increase value of the property that was aimed to be realized after the sale of the property.[864]

This is a perfect case where it can be demonstrated that the director's bona fide business decision made with an aim to benefit the company from the growth of the property's value overtime establishes a Non-Programmed (Creative) Business Decision. This is so, even though the end result led to the frustration of the overage covenant and that no profit was made whatsoever by the company.

[864] See Practical Law Company (online database) for overage payment in general including its definition <http://uk.practicallaw.com/4-200-2514> last access 2018

CASE STUDIES ON BUSINESS DECISIONS INVOLVING CONFLICT OF INTEREST AND BAD FAITH

CASE STUDY 1: *ZAVAHIR V. SHANKLEMAN* [2017] BCC 500 (CH)

Facts: The Company was set up by the occupants of the four flats for the purpose of acquiring and managing the freehold of the block of flats within with the four flats comprising.

All the directors and shareholders knew, for a fact, that the company did not have any profit available for distribution. However, one of the directors went ahead and granted a long-term lease extension to the shareholder for an undervalue price. Thus, resulted in the reduction of the company's value. The claimant (a director and shareholder of the company) sought permission to bring a derivative claim against another director and shareholders on the ground that the long lease extension constituted an undervalue transaction which in effect constituted a breach of s830(1) of Companies Act 2006, 'A company may only make a distribution out of profits available …'

The court considered that the claimant had presented more than a prima facie case. However, the claimant was not able to satisfy the second stage of the claim, i.e., the claim was not a claim of which a hypothetical director would seek to continue in the interest of the company under section 172.

This decision was made based on reason that the claim failed to satisfy the assessment of the overall cost due to the company not having the conduct of the business. In other words, even if the company won the case, it would not be able to recover the legal

cost involved in the case. In addition, the defendants have argued that the claimant director was not acting in good faith as the claimant, was seen by the court, to have treated the company as nothing but 'a nominee owner of the freehold'.

Comment: whilst the court in this case did not find it necessary to determine the good faith element. It did recognize that the hypothetical director seeking to discontinue the derivative action would be required to act in good faith as it was a requirement under section263(2)(a) taking into account of a hypothetical director acting in accordance with section 172. To this, the judge said, 'I have not found it necessary to reach any conclusion on the good faith or otherwise on any of the parties to this action …'[865] implying that even if the hypothetical director's decision to continue constituted an apparent Non-Programmed (Creative) Business Decision, the court would still reject the request to continue the claim if it became necessary for the court to reject on the basis of bad faith.

CASE STUDY 2: *BHULLAR V. BHULLAR* [2016] BCC 134 (CH)

Facts and Comment: The above view was in line with the decision in *Bullar v. Bhullar* where the transfer of the funds (made by the defendant director) into the company T, a company owned by the defendant director, was deemed to be an act of dishonesty. As the transfer was done without the prior authority of the other directors of the claimant company. A director must act in good faith, would be likely to

[865] *Zavahir v Shankleman* [2017] BCC 500 (Ch) [41]

promote the success of the company, to discontinue the derivative claim.[866] As the defendant director accepted that the transfer of the funds to company T was an act of bad faith,[867] the permission to continue the action was granted. Looking from the defendant director's perspective, the decision to transfer the funds was not a Non-Programmed (Creative) Business Decision as the condition of usefulness could not be satisfied in any event due to lack of good faith.

Interestingly, the court took the view, from the perspective of the claimant, in regard to a separate claim on an indemnity for costs (of which the claimant would not be entitled) and ruled that the claim was not made in good faith. This led to application for the n permission to continue the claim refused. To look at the issue from the other end of the spectrum, it could be said that the hypothetical director was acting in good faith and in the interest of the company, to discontinue the claim on the basis that the claimant was not entitle to the benefit of the pre-emptive indemnity.

CASE STUDY 3: *DODGE V. FORD MOTOR CO* 170 NW 668 [MICH 1919][868]

Facts: Henry Ford - the company director of Ford car manufacturing company decided to re-invest the company profits into developing a number of plants and machinery in anticipation of an increase car sale in the future. This business decision was made at the expense of withholding dividends from the shareholders.

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[866] Section 172 Companies Act 2006; see also *Franbar Holdi*ngs *Ltd v Patel* [2009] 1 BCLC 1, 11

[867] The defendant director in this case tried to rely on the statutory limitation as a defense instead *Bhullar v. Bhullar* [2016] BCC 134 (Ch) [27]

[868] See also Bus Law (1985) Vol 40, 1437, 1440

The company shareholders were not happy with the director's business decision, brought an action against the director. During the ruling, the judge commented that it was not within the capability of the judge to conclude whether or not the director's forecast of a massive increase of the company sale in the near future was accurate.[869] However, it later turned out that the director's forecast was correct and that the additional plant and machinery were indeed the correct business move to meet a rise in the number of cars within the company's production-line as a result of an increase in the consumers' demand.

Unfortunately, the court ruled the Henry Ford's business decision unlawful on the ground that it was made with an intention to benefit the general public rather the company itself.

Comment: the above business decision of the director would first appear to be a Non-Programmed (Creative) Decision as it has apparently satisfied the two basic conditions for creativity, namely, novelty and usefulness.

The decision was of novelty, as there was no predefined rule internally or externally of the company governing the re-investment decision and the directors' business

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[869] (Mich. 1919) 170 N W 668, 684 as cited by Robert Hamilton, *Corporations including Partnership and Limited Partnership, Cases and Materials* (2nd edn, West Academic Press 1981) 816

forecast. The judge admitted during the process of the litigation that '… the ultimate result of the larger business cannot be certainly estimated.'[870]

In theory, the decision would be deemed to be 'useful' to the company, not just it subsequently turned out to be profitable to the company as a result of the accurate forecast of the director, i.e., an increase of the consumers' demand for the cars; but even if the director's forecast turned out to be inaccurate, the company could still benefit from the director's re-investment decision through the acquisition of the plant and machinery. For instance, those assets could be use for 1. the development of new technology for expected competition whilst the old factories could be used to maintain the continuous car productions; 2. they could be turned into the company's potentially profitable, new business venture, such as Ford's mechanics factories; 3. the properties could be leased to a third party whereby the company obtains the profits by way of the rents and when the property market went up, they could be sold at a better value; 4. if the company owned the properties by way of leases, the company could, as a good practice of commercial property, assign the leases to a third party for profits; 5. a mixture of a business plan involving all of the above; or 6. the business expansion signified the economic outlook of the market sentiment with the potential effect to significantly boost up the company's share prices. This in turn benefited the shareholders in a greater deal than a mere single distribution of

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[870] Per Ostrander C J as cited by Robert Hamilton, *Corporations including Partnership and Limited Partnership, Cases and Materials (*2nd edn, West Academic Press 1981) 816

dividends. 'A company's share price tends to reflect not so much what it has achieved in the past but whether or not it is expected to grow earnings and profits in the future.'[871]

The 'usefulness' of Mr. Ford's proposed investment was implied by the judge whose view was, to a certain extent, in line with the above, 'It is recognized that the plan must often be made for a long future, for expected competition …'[872]

This case example when being taken within the context of creativity demonstrates that the issue of immediate profitability of a decision for the company is immaterial as far as the term 'usefulness' is concerned. This is because the decision can be useful to the company in an immediate non-profitable fashion, for instance, it is useful to achieve the company's growth as a long-term plan.

However, the court's final ruling was that Mr. Ford's business decision was unlawful as' … the powers of the directors are to be employed … for the profit of the stockholders …'[873] rather than, 'to the non-distribution of profits among stockholders

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[871] See online article – What Impacts Share Prices? <https://www.mywealth.commbank.com.au/learn/choosing-investments/what-impacts-share-prices-> accessed 2018

[872] *Dodge v. Ford Motor Co* 170 NW 668, 684 [Mich. 1919] as cited by Robert Hamilton, C*orporations including Partnership and Limited Partnership, Cases and Materials* (2nd Edn, West Academic Press 1981) 816

[873] ibid as cited by Lynn A. Stout, 'Why We Should Stop Teaching *Dodge v. Ford*' Va L & Bus Rev Vol 3, 164, 171

in order to devote them to other purposes…'[874] (N.B. with reference to 'benefiting the public').

This is a classic scenario where the conditions of novelty and usefulness are apparently present within the decision-making process of the director. But the absence of good faith renders the condition of 'usefulness' unsatisfied.

CASE STUDY 4: *NORLIN CORP. V. ROONEY, PACE INC.* [1984] 744 F.2D 255

Facts: Norlin Corporation – the largest manufacturer of music instruments in the United State during the 1980s, became a target for hostile company takeover bid launched by the Rooney, Pace Group in partnership with Piezo Electronics.[875]

After failing to obtain a temporary restraining order from the court preventing Rooney, Pace and Piezo Electronics to continue the purchase of Norlin shares, the directors of Norlin sought to dilute the hostile bidder's percentage of their Norlin shares as a measure to frustrate the proposed takeover.[876]

On February 13, 1984, the *Wall Street Journal* announced that Rooney, Pace and Piezo Electronics had raised their stake of Norlin common shares to 47.6

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[874] ibid as cited by Lynn A. Stout, 'Why we should stop teaching Dodge v. Ford' Va L & Bus Rev Vol 3, 164, 171

[875] 'Incompetence, Inc' *Forbes* (1 Dec, 1986) 40-51 as cited by John F. Uggen, 'The Day the Music Died: Rooney, Pace and the Hostile Takeover of the Norlin Corporation' TheBHC (2010) < https://thebhc.org/sites/default/files/uggen.pdf> accessed 2018

[876] Richard D. Truedell JR, 'Does Norlin Corp. v. Rooney, Pace Inc. Preserve for Shareholders Control of a Corporation's "Ultimate Destiny?"' (1986) 20 Colum J L & Soc Probs 325, 327; and John F. Uggen, 'The Day the Music Died: Rooney, Pace and the Hostile Takeover of the Norlin Corporation' TheBHC (2010) < https://thebhc.org/sites/default/files/uggen.pdf> accessed 2018

> percent. Norlin management argued, however, that the hostile stake represented only 42.3 percent after the issuance of the nearly one million new shares.[877] On March 16th the New York Stock Exchange delisted Norlin, charging that a change in control had taken place 'without prior notification to shareholders, and that the issuance of the new preference shares violated the exchange's listing criteria for public ownership of stock.'[878]

The case subsequently went to the court against the director of Norlin for the violation of the exchange listing criteria by unlawful issuance of the company shares without prior notification to the shareholders. The increase share capital was subsequently held by the court to be unlawful.

Comment: the directors' business decision to increase the number of shares as a method of preventing the hostile takeover could not be a Non-Programmed (Creative) Business Decision even if the first two criteria of the types of the decision could be satisfied; This is due to the fact that 'the directors offered no rationale to shareholders other than its determination, to oppose, at all costs, the threat to the company that Piezo's acquisitions ostensibly represented.'[879] The business decision was clearly a

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[877] 'Norlin Hostile Holders Stake Rises to 47.6%' (1985) WSJ B1 as cited by John F. Uggen, 'The Day the Music Died: Rooney, Pace and the Hostile Takeover of the Norlin Corporation' TheBHC (2010) < https://thebhc.org/sites/default/files/uggen.pdf> accessed 2018

[878] John F. Uggen, 'The Day the Music Died: Rooney, Pace and the Hostile Takeover of the Norlin Corporation' TheBHC (2010) < https://thebhc.org/sites/default/files/uggen.pdf> accessed 2018

[879] *Norlin Corp. V. Rooney, Pace Inc* (1984) 744, F2d 255, 265; also, as cited by John F. Uggen, 'The Day the Music Died: Rooney, Pace and the Hostile Takeover of the Norlin Corporation' TheBHC (2010) < https://thebhc.org/sites/default/files/uggen.pdf> accessed 2018

matter of conflict of interest with the directors not having the intention to act in the best interest of the company[880] – the element (conflict of interest) that defeats business creativity; the element also renders the law relating to liability for negligence inoperable.

The business judgment rule 'did not allow activities that were nothing more than a tool of management self-perpetuation.'[881]

This ruling bears a striking resemblance to the UK law whereby directors can be held criminally liable for their improper use of the power to allot shares. For instance, in *Howard Smith Ltd v. Ampol Petroleum Ltd*, where the company was under the threat of the takeover bid. The company directors increased share capital with an attempt to defeat the proposed takeover through a dilution of the bidders' existing share capital. Thus, reducing the bidders into minority shareholders. This share allotment was not deemed to be exercised in good faith for the benefit of the company[882] as the allotment that had been undertaken by the directors was not in connection within their management power. Rather, it was a misuse of the directors' power to allot shares to simply defeat the proposed takeover. Consequently, the allotment of shares was held invalid.

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[880] E. Norman Veasy & Julie M.S. Seitz, 'The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project – A Strange Porridge' (1985) 63 Tex L Rev 1489, 1483; and Stephen Bainbridge, T*he New Corporate Governance in Theory and Practice* (OUP USA 2008) 147

[881] 'Norlin Hostile Holders Stake Rises to 47.6%' (1984) WSJ, B1 as cited by John F. Uggen, 'The Day the Music Died: Rooney, Pace and the Hostile Takeover of the Norlin Corporation' TheBHC (2010) < https://thebhc.org/sites/default/files/uggen.pdf> accessed 2018

[882] (1974) AC 821 (PC) 835

CASE STUDY 5: *LEXI HOLDINGS PLC V LUQMAN AND OTHERS* [2007] EWCA 2652 (CH)

Facts: The company has gone into insolvency proceedings, and it transpired that the managing director had misappropriated over fifty-nine million pounds from the company's bank loan. The administrator obtained the court judgment to recover approximately forty million pounds from the other two directors who were not directly involved in the bank loan misappropriation, on the grounds that the two directors who happened to be the sisters of the managing director, had the knowledge that their brother had served two terms of imprisonment for deception. And added on top with the facts that the two directors should have known the misappropriation from the company bank account but turned a blind eye to the misappropriation through their deliberate failure to inform the company auditor and other directors of the facts.[883]

Comments: Unlike the previous two cases, this is the case where the decisions of the directors fail to constitute a Non-Programmed (Creative) Business Decision both on the relevant conditions, as well as, the interference of bad faith.

The two directors' business decisions could constitute conflict of interest due to the managing director being their brother. Their business decisions constitute dishonesty

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[883] See *Mayson, French and Ryan on Company Law*, (34th edn, OUP Oxford 2017 - 2018) 497; and Online Article by Ed Weeks, 'Rubber Stamping by Directors Can Lead to Liability – *Lexi Holdings v Luqman*' https://www.cripps.co.uk/rubber-stamping-by-directors-can-lead-to-liability-lexi-holdings-v-luqman-2/ accessed 2018

and bad faith against the company due to deliberate breach of duty to attend to the company's affair at the detriment of the company.[884] In view of the element of bad faith, it is immaterial to determine the type of business decisions made by the sisters in this case. The inaction of the sisters constitutes breach of the directors' duty to supervise as part of their functional responsibility. Thus, breach of the process of making proper programmed business decisions. In any event, the concept of Non-Programmed (Creative) Business Decision is inoperable.

THE AGENCY COSTS AND THE STRATEGIES

The above section, I have discussed the types of business decisions from a psychology perspective. I then adopted the case studies to demonstrate how each of these types of decisions fit into the case law scenarios, leading to the examination of the judicial or legislated deference from a psychology perspective.

In Chapter Three, I discussed the agency costs[885] and the difference of its effects as an enforcement of bounded rationality on both company directors and judges. Led to the conclusion that judges are more boundedly rational than directors due to the judicial constraints that led to a greater degree of incentive for agency costs. In the

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[884] *Lexi Holdings PLC v Luqman and Others* [2007] EWCA 2652 (Ch) [38]

[885] Kraakman et al described the agency costs as, '…because the agent commonly has better information than does the principal about the relevant facts, the principal cannot easily assure himself that the agent's performance is precisely what was promised. As a consequence, the agent has an incentive to act opportunistically, skimping on the quality of his performance, or even diverting himself some of what was promised to the principal.' Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 27

following section, I will revisit the issue of the agency costs, I will discuss the strategies companies have used to reduce directors' agency costs. The section will demonstrate, whilst directors can be subject to agency problems, their behaviour can, unlike judges, be controlled by a number of strategies. Whilst judicial or legislated deference promotes the intrinsic motivation in directors' business creativity, there are, at the same time, strategies (non-litigation in nature) that can be adopted to minimize agency costs. In turn, these strategies ensure that company directors' business decisions (irrespective the types) are made in good faith and in the interest of the company. As mentioned in Chapter Four and the following of this chapter, these strategies, from a psychology perspective, do not serve as a controlling extrinsic motivation that hinders directors' business creativity due to the 'no choice' condition. This is different to derivative suits (in the absence of judicial or legislated deference).

The strategies that have been commonly used by shareholders/companies against directors' agency costs are as follows:

RIGHT TO SELL OUT (TRANSFER) & RE-ELECTION OF THE BOARD

It has been argued that company shareholders under normal circumstances entered into contractual relationship with directors on voluntary basis with an option to choose the deal. As correctly pointed out by Irvine that, 'No one forces an investor to buy stock and thereby participate in corporate democracy'.[886] This can be evidenced

[886] William Irvine, 'Corporate Democracy and Rights of Shareholders' (Jan, 1988) J Bu Ethics Vol 7, 99 107

by Section 112(1) and (2) of the Companies Act 2006 which provides that an individual can only become a member of a company if his or her name is registered as a shareholder and that he or she had consented the name to be registered. Shareholders are also the persons who elected the board.[887]

Shareholders who disapprove the directors, could therefore, either do a shares sell-out[888] – 'In the absence of restrictions in the articles the shareholder has by virtue of the statute to transfer his shares without the consent of anybody to any transferee.' - *Re Discovery Finance Corporation Ltd, Lindlar's Case.*[889] Kraakaman et al have argued that an unrestricted right of transfer of shares[890] can be an efficient tool to discipline directors as the right of transfer 'allow hostile takeovers in which the disaggregated shareholders of a mismanagement company can sell their shares to a single active shareholder with a strong financial interest in efficient management.'[891]

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[887] Ralph A. Peeples, 'The Use and Misuse of the Business Judgment Rule in the Close Corporation' (1984-85) 60 Notre Dame L Rev 487; and H. Henn & J. Alexander, '*Law of Corporations*' 661-663 (3rd edn, 1983) both cited by Frankiln A. Gevurtz, *Corporation Law*, (2nd edn, West Academic 2010) 293; See also Mayson, French & Ryan, *Mayson French and Ryan on Company Law* (34th edn, OUP Oxford, 2017-2018) 434-425

[888] Also known as shareholders' 'right of transfer' as descried by Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 33-34; under Directive 2001/34/EC, art 46(1); and LR 2.2.4R(1) shares of listed companies are normally freely transferable; the right of transfer of shares (governed by the company's articles) is also stated in section 544(1) Companies Act 2006.

[889] [1910] 1 CH 312 (Ch) 316. Also as cited by Mayson, French & Ryan, *Mayson, French & Ryan on Company Law* (34th edn, OUP Oxford 2017-2018); See also Susan Mcluaghlin, *Unlocking Company Law* (5th edn, Routledge 2015) 434

[890] It should be noted that the right of transfer in a private company, as per the company's article of association, most likely need a prior approval of the directors who have the right to refuse to register the transfer of shares.

[891] Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 34

This, in turn, pose a threat of having the existing directors being replaced with another group of directors.

Apart from being an effective tool for disciplining management, Dow and Gorton have pointed out that shareholders' right of transfer of their shares can also be used as an indication or standard to assess management performances through share prices.[892] '… by increasing transparency for existing investors and potential bidders about whether the company is underperforming under its current management team.'[893]

Now, this ties in with the so called 'Comply & Explain approach' as set out in in UK Corporate Governance Code[894] whereby the premium listed companies are required to comply with the standard of governance relating to matters such as the effective management and relations to the shareholders. This would ensure the transparency relating to the making of any Non-Programmed (Creative) Business Decision. The business decision backed by an appropriate risk management that is accurately reflected in the information given by the directors to the shareholders will be expected. Directors will also be expected to maintain a proper dialogue with the shareholders to achieve mutual understanding of corporate objectives which include any proposed Non-Programmed (Creative) Business Decision. If the directors do not wish to

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[892] James Dow and Gary Gorton, 'Stock Market Efficiency and Economic Efficiency: Is There a Connection?' (1997) J. Finance 1087 as cited by Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 35

[893] Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 35

[894] The UK Corporate Governance Code, paras 9.8.6R(5) and 9.8.6R(6); *and* Listing Rules, para 9.8.7R

comply with these standards, then they would be required to disclose the non-compliance and explain to the investors the reason behind the non-compliance. This gives the shareholders an opportunity to sell their shares if the explanation fails to satisfy the shareholders.

Apart from the right of transfer, shareholders of, in particular – non-public companies can sell back their shares, for instance, through unfair prejudice claim where the minority members' interests have been unfairly prejudiced by way of which the company's affair is being conducted (Section 994 of the Companies Act 2006).

Shareholders may also re-elect the board as pointed out by Scott that 'The cost of bad decision, on the other hand, can be reduced by replacing managers who exhibit inferior judgment, including at times the managers at the top.'[895] Kraakman et al have also pointed out the shareholders' right of selection and removal as measures to reduce agency costs, 'Given a central role of delegated management in the corporate form, it is no surprise that *appointment rights* – the power to select or remove director (or other managers) are key strategies for controlling the enterprise.'[896] Keay has made a reference to a result of an empirical study that 'replacing management was

[895] Kenneth E. Scott, 'Corporation Law and the American Law Institute Corporate Governance Project', 35 Stan L Rev 927, 936

[896] Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 37

also seen as a quick and cheap way of' discipline company directors who behave poorly.[897]

The right to remove company directors is re-affirmed by Section 168 of the Companies Act 2006 (whose predecessor is Section 303 of the Companies Act 1985[898]) which confers a non-exclusive right (*Re Peveril Gold Mines Ltd*[899]) to the shareholders to include provisions 'for dismissal of a director without special notice and without permitting the director to make representations (*Brown v. Panga Pty Ltd* [1995]).'[900] Consequently, to remove the directors, all the members of the company need is a passing of an ordinary resolution[901], i.e., Section 168(1) states that 'A company may by ordinary resolution at a meeting remove a director before the expiration of his period of office, notwithstanding anything in agreement between it and him'.

The position of the shareholders' right to remove directors is enhanced by the non-exclusion of security of tenure of directorship. As pointed out by Kershaw and Cheung that it is clear from the latter part of Section 168(1), i.e., '… notwithstanding

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[897] J. Holland, 'Influence and Intervention by Financial Institutions in Their Investee Companies' (1998) 6 Corporate Governance 249, 255 as cited by Andrew Keay, 'Company Directors Behaving Poorly: Disciplinary Options for Shareholders' (2007) J.B.L. 656-682, 662

[898] See for example, Colin Mercer, 'Section 113 and 114 – Written Resolutions: What About Table A?' (1991) Comp Law 220-221

[899] [1898] 1 CH 122 (CA) as cited by Mayson, French and Ryan on Company Law Mayson, French & Ryan, *Mayson, French & Ryan on Company Law* (34th edn, OUP Oxford 2017-2018) 81, 441. See also Practical Company Law (Online Data Base) <http://uk.practicallaw.com/1-528-9825> access 2018

[900] Mayson, French and Ryan, *Mayson, French & Ryan on Company Law* (34th edn, OUP Oxford 2017-2018) 441 - 442

[901] A simple majority of more than 50% of the shareholders' vote (Companies Act 2006, sections 282(2), (3), & (4))

anything in agreement between it and him' that a director 'does not, therefore, have any formal security of tenure.'[902] In other words, one cannot contract out the mandatory right of shareholders to remove directors by way of ordinary resolution as prescribed by the Companies Act 2006.

The non-excludable right of shareholders to remove directors is significant to shareholders' powers as the mechanism encourages market self-regulation. In other words, if the shareholders are not happy with the director's business performance, then they could exercise their right under Section 168.

In the absence of security of tenure relating to directorship, in practice, however, can lead to a desire to include a severance provision in the directors' contract[903] with the company. This has been seen in the case of *Re Walt Disney Derivative Litigation*[904] but the director negotiating the contract of employment on behalf of the company will be encouraged to exercise his Non-Programmed (Creative) Business Judgment to negotiate an appropriate severance payment provisions between of the parties. For instance, although it is not possible to contract-out judicial or legislated deference in favour of directors, an exception could be made to exclude or reduce the sum of

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[902] Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP Oxford 2012) 222; and Rita Cheung, 'Shareholders Agreement – Shareholders Contractual Freedom in Company Law' (2012) JBL 516

[903] Mayson, French and Ryan, *Mayson, French and Ryan on Company Law Mayson*, (34th edn, OUP Oxford 2017-2018) 443

[904] [2006] (Disney V). 07 A. 2d 693; see also Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP Oxford 2012) 222; and Rita Cheung, 'Shareholders Agreement – Shareholders Contractual Freedom in Company Law' (2012) JBL 516

severance payment if the director is dismissed on the ground of negligence and unreasonable behaviour. The scope and extent of the limitation to severance payment in the directorship contract will much depend on the bargaining positions and the level of creativity of the respective parties.

This strategy, from a psychology perspective, does not constitute a controlling extrinsic motivator as the element of controlling extrinsic motivator is extinguished by the 'no choice' condition.[905]

UTILITY OF CORPORATE COMPENSATION

It has been pointed out by some academic writers[906] that the problems associated with agency costs can be mitigated by using certain methods in conjunction with the system that insulates directors from derivative suits, e.g., corporate market regulation which could optionally include the utility of executive compensations (stock ownership of directors or director's performance related pay[907]).

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[905] See Chapter Four; and the Utility of Corporate Compensation below for more relevant information.

[906] See for instance, Stephen G. Marks, *Encyclopaedia of Law and Economics - The Separation of Ownership and Control'* (Edward Elgar Publishing Ltd, 1999) 692, 692 & 706; and Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 35, 36

[907] An interesting note that in recent years, the use of executive compensation has caused public outcry due to the massively high levels of executive pay. 'Inappropriate levels of executive rewards have destroyed public trust and led to a situation where all directors are perceived to be overpaid.' Julia Werdigier, 'In Britain, Rising Outcry over Executive Pay that Makes "People's Blood Boil"' (2012) <https://www.nytimes.com/2012/01/23/business/in-britain-a-rising-outcry-over-lavish-executive-pay.html > accessed 11th November 2018

The method of utility of corporate compensation as the judge in *Slosh v. Telex Corp*[908] said that the market operates as a corporate control would replace the judicial intervention in ensuring that company directors are encouraged to strive more for making good (and I add - creative) business decision for the success of the company.[909] Here, we can see that the policy behind the judicial deference backed by the corporate deterrence is clearly referring to the justification of encouraging directors to take business risk, i.e., to be business creative.

The corporate deterrence could include the directors (or agents') own human desire of wanting to achieve their psychological 'incentive of conscience, pride and reputation'.[910] Karaakman et al has said that this type of incentive 'correspond with… intrinsic motivation'[911] in psychology. The corporate deterrence or market regulation can also incur by way of corporate takeover, whereby the agency problem created by the directors resulted in the company being taken over by another company. And given the poor business performance of the existing directors, the new owner of the company might desire to replace the directors with another group of directors.[912] Kraakman et al described this type of corporate control in line with extrinsic

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[908] [1988] (Del. Ch.) 13 DEL.J. CORP. J. L. 1250, 1262 as cited by Kenneth B. David, JR, 'Once More, The Business Judgment Rule' (2000) WIS.L Rev. 573, 580

[909] ibid.

[910] Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 35

[911] ibid

[912] This ties in with the threat of removal as previously mentioned as one of the strategies against agency problem, i.e., instead of being removed by the existing shareholders of the company, the threat of removal comes from the new owners of the company.

motivation in psychology[913] (but not controlling extrinsic motivation as I shall explain immediately below).

It is essential to know that, from a psychology perspective, the utility of corporate compensation does not constitute a controlling extrinsic motivation (as opposed to the derivative suit in the absence of judicial or legislated deference). As already mentioned in Chapter Four – Controlling Extrinsic Motivator affected by 'no choice' condition, and I here reiterate, that this is because psychology studies have demonstrated the difference between the legal action and the market regulation. In that, as opposed to legal action by way of derivative claim regime (in the absence of judicial or legislated deference), directors' intrinsic motivation is less likely to be affected adversely by market regulation. This is because with market regulation, the element of punishment comes with less or no choice. In other words, directors can be derivatively sued for their negligence within the process of business creativity but they would not be sued for adopting a more conservative business approach without taking business risk arisen from creativity. However, directors can damage their corporate reputation for either causing financial loss to the company as a result of their business negligence; or they can damage their corporate reputation for not exercising business creativity and thus, rendering the company less commercially competitive.

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[913] Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 35

An objects clause lays down the capacity and power of a company. Historically, a designated object of a company was a concession by the state for individuals to operate business through corporation. In other words, the state gave the power to companies, subject to the condition that companies must not act outside the designated power as it would cause uncertainty for investors on their overall investment strategy, thus, the absence of an objects clause restricting the power of companies that time was deemed to be against the public interest.[914]

It follows that prior to the reform of Companies Act 1989, companies were required to have an objects clause in its memorandum of association and any act of the company that goes beyond the limitation of the objects clause would be deemed to be ultra vires, i.e., beyond the power of the company and void. For instance, in the case of *Re Introductions Ltd*[915] where it was held that as pig-breeding business was not within the scope of the company's objects, therefore, the loan that had been granted for the purpose by the money lender (with the full prior knowledge of the ultra vires) was unenforceable against the company.

The requirement for an objects clause has now been abolished by the Companies Act 1989 as subsequently amended by Section 31(1) of the Companies Act 2006. The Companies Act 2006 states that - Unless the company's articles specifically restrict

[914] See Alan Dignam and John Lowry on Company Law, (6th edn, OUP 2010) chapter 12
[915] [1970] CH 199 (CA)

the objects of the company, its objects are unrestricted. Under the Companies Act 2006, company memorandums have now become historical artifacts and the objects clause of any existing company have now been transferred to the articles, 'from which it may be deleted by special resolution (section 21) unless it is subject to the provisions for entrenchment.'[916]

This reform allows the shareholders to have an option to either restrict company directors' power engaging in certain type of business[917] or to give directors an unrestricted power to deal with any kind of legal business. The option of restrictions on objects clause, of course, cannot prevent directors from exercising Non-Programmed (Creative) Business Decisions. As such type of decisions can be made even with the existence of the objects clause, i.e., creativity can still be invoked within one type of business. It simply ensures that shareholders or potential share investors would, to a reasonable extent, have the prior knowledge as to the kind of business of which the directors' Non-Programmed (Creative) Business Decisions can be made. Furthermore, although no longer applicable to the third party entering into the contract with the company, the ultra vires doctrine would still be operable internally against the directors under section 171 Companies Act 2006 which requires all directors (a) 'to act only in accordance with the company's constitution'; and (b)

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[916] Mayson, French & Ryan, *Mayson, French & Ryan on Company Law* (34th edn, OUP Oxford 2017-2018) 104

[917] Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 31

'only exercise power for the purpose of which they are conferred'. This gives the shareholders the right to seek an injunction to prevent director from acing ultra vires.

In addition to the limitation of directors' power through an objects clause in the article of association, the Model Article (both private and public companies) also reserves shareholders the power to '… by special resolution, direct the directors to take, or refrain from taking, specific action'.[918] As provided by the above articles, one can see that the UK law attempts to achieve a balance of distribution of powers between directors and shareholders through giving directors general powers in business decision-makings but subject to any alteration by way of shareholder' special resolution. In other words, whilst directors enjoy a wide scope of decision-making powers within the Model Articles, shareholders can override the directors' powers either to direct them to take a particular business decision or to prevent them from taking a particular business decision, as long as the shareholders achieve a passing of a special resolution. However, despite the shareholders' right of intervention, the Model Articles confers business decision-making power onto shareholders, it does not allow shareholders to 'invalidate anything which the directors have already done.'[919]

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[918] Article 4(1)
[919] Article 4(2)

Kraackman et al used the term 'gatekeeper control' to describe the employment of non-corporate actors to supervise the behavours of company directors.[920] Gatekeepers could include a number of parties whose professions are relevant for the purpose of supervising corporate conducts, for instance, these gatekeepers can be accountants or auditors.[921] Gatekeeper control can take the form of the employment of non-executive directors.[922] The key responsibilities of non-executive directors include '… scrutinize the performance of management in meeting agreed-goals and objectives and monitoring …'[923]; and 'satisfy themselves that financial information is accurate and that financial controls and system risk-management are robust and defensible'.[924] In other words, non-executive directors supervise the corporate conduct of executive directors, making sure the accuracy of all the relevant information in executive directors' business decision-making process; and the implementation of the business decision(s).

Inevitably, the use of gatekeepers/non-executive directors can generate the issue of agency costs against the principal/company. However, the risk of agency costs between the gatekeepers/non-executive directors and the principal/company can be

[920] Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 42
[921] ibid
[922] The UK Corporate Governance Code (2016), para. B.1.1 states that Non-executive directors in the UK are required to be 'independent in character and judgment'.
[923] Derek Higgs, 'Review of the Role and Effectiveness of Non-Executive Directors' (2007) < https://web.archive.org/web/20070610171658/http://www.dti.gov.uk/files/file23012.pdf> accessed 10th November 2018; See also the UK Corporate Governance Code.
[924] ibid

reduced by 'the application of the basic legal strategies to the gatekeepers themselves, with chief reliance on the standard and trusteeship strategies.'[925] As pointed out by Yermack, non-executive directors have turned their outside directorship status into professions whereby increases in their management reputation would open them to better opportunities of securing other non-executive directorship contracts with other companies. The relevant financial incentives cannot be trivial.[926]

As opposed to executive directors, the gatekeepers' roles are of are, by nature, supervisory, i.e., programmed business decisions, as opposed to creative, i.e., Non-Programmed (Creative) Business Decisions. Legal strategies therefore, does not have the issue of de-motivating business creativity. The legal enforcement of the duties of non-executive directors can be limited as In *Re Westmid Packing Services Ltd*[927] it was held that directors (likely to include non-executive directors) must keep themselves properly informed of the company's affairs irrespective the dominance of another party. However, in *Re Polly Peck International Plc (No 2)*[928] the court refused to hold the non-executive directors liable for not being, as it was not realistic to require them to control a powerful dominant director who was planning to remove the non-executive directors.

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[925] Kraakman et al, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, (3rd edn, OUP Oxford, 2017) 43

[926] David Yermack, 'Remuneration, Retention and Reputation Incentives for Outside Directors' (2004) J.Finance 2281, 2307

[927] [1998] BCC 836 (CA)

[928] [1994] 1 BCLC 574 (Ch) 604

Premium listed companies in the UK are unlikely to be exposed to the issue of independent judgment in a fashion as shown in *Re Polly Peck International plc (No 2)* as the UK Corporate Governance Code[929] requires the board to '… include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision-making. Again (as discussed earlier on this chapter), any non-compliance to this requirement will place the directors under an obligation to disclose to the shareholders with an explanation as to the non-compliance. This gives an opportunity to any dissatisfied shareholders to sell their shares.[930]

SUMMARY

Whilst company directors are expected to exercise business creativity in their business decision-making, balance has to be maintained between judicial or legislated deference and mitigation of the agency costs. To demonstrate the minimization of the potential agency problems in the process of directors' business decision-making, a number of strategies have been discussed in this chapter.

Company shareholders are equipped with a number of protections to prevent or minimize unsatisfactory or agency costs associated business decisions made by the

[929] Financial Reporting Council, 'The UK Corporate Governance Code' (2018) <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.PDF> accessed 10th November 2018

[930] See ft 878

directors. Shareholders are allowed to transfer their shares either to a third party; or the company (via the unfair prejudice[931] claim upon satisfying the legal conditions); they are allowed, by majority votes, to replace the board; and they are allowed, by majority votes, to restrict the business objects of the company.

In the UK, listed companies are expected to comply with the standard of corporate conduct imposed by the UK Corporate Governance Code. Directors are required by the Code to disclose to the shareholders of any non-compliance of the standard. Shareholders (who are dissatisfied with the directors' explanation for non-compliance) can take pre-emptive actions, e.g., to sell their shares.

Shareholders can also mitigate the risk of agency costs through the use of the gatekeepers/non-executive directors, making sure that the directors' proposed business decisions are substantiated by accurate financial information, with the gatekeeper's supervision carried out under a robust risk management system.

Froma corporate perspective, agency costs can also be minimized by way of the utility of corporate compensation such as the market regulation. Market regulation is arguably (as opposed to derivative suits in the absence of judicial or legislated deference) an effective way of controlling the management without de-motivating the directors' business creativity.

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[931] Such action normally being brought by shareholders of small and non-public companies.

These strategies, unlike derivative suits (in the absence of judicial or legislated deference), do not constitute controlling extrinsic motivator due to the 'no choice' condition. These strategies can therefore, be used alongside judicial or legislated deference without adversely affecting directors' business creativity, whilst ensuring mitigation of agency costs.

NON-PROGRAMMED (CREATIVE) BUSINESS DECISION AND THE COMPANY SHAREHOLDERS

The above sets out the strategies to counter the agency problems. In the following, I will move on to discuss the relationship of the concept of Non-Programmed (Creative) Business Decisions and company shareholders. I will also demonstrate a number of reasons as to why the concept is beneficial to shareholders. This discussion will be based on both the existing academic literatures and will make relevant references to the Companies Act 2006.

The discussion will also be conducted through presenting the following arguments to demonstrate the impact of judicial deference or legislated deference by way of Non-Programmed (Creative) Business Decision to company shareholders. These arguments will demonstrate that the shareholders are deemed to be of 'lesser victims' when Non-Programmed (Creative) Business Decisions go wrong; and at the same time, demonstrate that they are in fact, the beneficiaries of directors' Non-Programmed (Creative) Business Decisions:

Shareholders have the choice of protecting themselves with a diversified share portfolio in different companies, which in turns minimizes the risk of the directors' mismanagement, or having a disagreement with the directors' business decisions.[932] Gurvetz has pointed that it has been argued by certain judges that 'in the case of diversified shareholders, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will overtime be offset by even greater gains in others ... ';[933] and 'Shareholders can diversify the risk of their corporate investments'.[934] Irvine has also pointed out that, 'If an investor does decide to buy stock, he has a choice, in America, of perhaps eight thousand companies to invest in.'[935] Thus, 'it is in their economic interest for the corporation to accept in rank order all positive net present value investment projects available to the corporation, starting with the highest risk adjusted rate of return first'.[936]

Therefore, negligence liability that discourages the continuation of directorship or business risk taking should be replaced by the business judgment rule[937] and in this

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[932] E.J.Elton and M. J. Gruber, 'Risk Reduction and Portfolio Size: An Analytic Solution' [1977] J Bus Vol 50, 415-437

[933] Per Ralph Winter in *Joy v. North* 692 F. 2d 880, 885, 886 [1982] as cited by Frankiln A. Gevurtz, Corporation Law (2nd edn, West Academic 2010) 293

[934] ibid

[935] William Irvine, 'Corporate Democracy and Rights of Shareholders' (Jan, 1988) J Bus Ethics, Vol 7, 99, 107

[936] Per Chancellor Allen in *Gagliardi v. Trifoods Int'l, Inc.* 683 A.2d 1049, 1052 [Del. Ch. 1996] as cited by Franklin A. Gevurtz, (2nd edn, West Academic 2010) 293

[937] Annete Greenhow, 'The Statutory Business Judgment Rule: Putting the Wind into Directors' Sails' (1999) BondLawRw Vol 1142; and Alfred. F. Conard, 'A Behavioral Analysis of directors' Liability for Negligence' (1972) Duke LJ 904; and Einsenbeg, 'The Duty of Care of Corporate Directors' (1989-1990) 51 U Pitt L Rev 958-959

thesis – company law's deference in the context of the Non-Programmed (Creative) Business Decisions. The importance of the avoidance of discouraging directors from taking business risk is in line with the UK judges stance. For instance, in *Overend Gurney & Co v. Gibb*[938] - where the judges agreed that directors should be encouraged to take business risk as the directors operate in business environment need to have ' … a great deal more readiness to confide in the probabilities of things, with regard to success in mercantile transactions…'; or as per Newey J in Newey J in *Kleanthous v. Paphitis* [939] who followed the no-threshold on the merits principles laid down by Roth J in *Stainer v Lee*[940] & Lord Reed in *Wishart v Castlecroft Securities Ltd*[941] concluded the general commercial factors, such as the adverse effect of litigation on the director's business decisions to cause disruption to the morale of the company's senior management; or making directors risk adverse, thus reducing the maximum trade performance of the company would discontinue the derivative claim against the directors.

The advantage of risk diversification in company shares have also been echoed by Fischel as he has mentioned in his article that,

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[938] [1872] LR 5 (HL) 480 as cited by Kershaw, *Kershaw Company Law in Context: Text and Materials* (2nd edn, OUP Oxford 2012) 423

[939] [2011] EWHC 2287 (Ch)

[940] [2010] EWHC 1539 (Ch) as cited by Newey J in *Kleanthous v. Paphitis* (2011) EWHC 2287 (Ch) [40]

[941] [2005] CSIH 63 (CSIH) [37] as cited by Newey J in *Kleanthous v. Paphitis* [2011] EWHC 2287 (Ch) [71], [72] & [73]

shareholders, because of their ability to invest in many firms, are better able to bear business risk than corporate managers. The bankruptcy of an airline company, for example, might be a disaster for its employees and managers who lost their jobs but a matter of indifference to its investors who own shares in other airline companies that obtain the bankrupt company's routes.[942]

CORPORATE DEMOCRACY

The term 'democracy' refers to, 'the possibility of aligning the power of the individual with the needs of community through a sense of common purpose.'[943] Thus, Corporate Democracy refers to the concept of guaranteeing the company directors business decision-making power conferred upon by the majority shareholders of the company for the best interest of the company. In other words, it refers to 'Maintaining a proper balance in the allocation of power between the stockholders' right to elect directors and the board of directors' right to manage the corporation ...'[944]

Consequently, it is the duty of the directors, rather than shareholders (whether or not by way of judicial intervention) to make business decisions on behalf of the company. As the Judge in *Kamin v. American Express Co* mentioned, 'The Directors' room

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[942] Daniel R. Fischel, 'The Business Judgment Rule and the Trans Union Case' (1985) The Bus Law Vol 40, 1437, 1442

[943] Gjalt De Jong and Arjen Van Witteloostuijn, 'Successful Corporate Democracy: Sustainable Co-operation of Capital and Labor in the Dutch Breman Group' Aca Manag Exec (2004) Vol 18 54-66, 55

[944] *MM Companies Inc. v. Liquid Audio,* No. 606, Del Sup Ct Jan 17, 30 [Del. 2003] as cited in <https://www.sec.gov/rules/proposed/s71903/wisinvboard122203.htm.> accessed 2018

rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive stations, or tax advantages.'[945]

The concept of corporate democracy has been clearly echoed by judges in the UK cases such as *Howard Smith Ltd v. Ampol Petroleum Ltd*[946]; *Smith v Croft (No. 2)*;[947] and *Allen v. Gold Reefs of West Africa Ltd*[948] where the judges showed their diffidence to interfere with the management decisions of the boards who, in their decision-making process, were acting as an appropriate independent organ of the company.

SHAREHOLDERS' PREFERENCE TO NON-PROGRAMMED (CREATIVE) BUSINESS DECISIONS BACKED BY JUDICIAL OR LEGISLATED DEFERENCE

'Shareholders, as a class, want managers to take more risk than they might otherwise be willing to.'[949] As directors' creativity in entrepreneurial ventures is of the essence for the company's success and profitability. This risk-taking element exercised in a corporation serves as a trading vehicle is a feature that non-corporation

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[945] 383 N.Y.S.2d at 810-11 [1976] (as cited in Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vand L Rev 98, 120; & Stephen M. Bainbridge *The New Corporate Governance in Theory and Practice* (OUP USA 2008) 111)

[946] [1974] 821 (PC) 832

[947] [1988] Ch 114 (Ch) as cited by Mayson and French and Ryan, *Mayson and French and Ryan on Company Law* (23rd edn, OUP Oxford, 2006-2007) 664

[948] [1990] 1 CH 656 (CA)

[949] Danile R. Fischel, 'The Business Judgment Rule and the Trans Union Case' (1985) Bus Law Vol 40, 1437, 1442

investments do not have. It evidently follows that, 'If shareholders wanted to avoid risk, they would have purchased government bonds rather than shares of stock'.[950]

It follows that shareholders' preference to Non-Programmed (Creative) Business Decisions would lead to the desire of wanting to ensure that company directors' willingness to take a business risk is not being fettered by judicial intervention. As pointed in Chapter Four that Judicial intervention on business judgment through negligence liability constitutes Controlling Extrinsic Motivator that discourages directors from taking appropriate risks by way of Non-programmed (Creative) Business Decisions. Chapter Four also mentioned the interruption of the board's group dynamics through the possibility of an increase the type of diligence towards the agency costs that shareholders would not want. As pointed out by Conard, that under the threat of negligence liability, directors instead of exercising diligence to maximize the company's profits and growth, more efforts are likely to be made to protect the directors themselves from negligent claims. In other words, directors are likely to exercise diligence in seeking expert opinions in the situations where they are clearly not necessary to do so. Consequently, these agency costs would inevitably be damaging to the company both financially and timely.[951]

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[950] ibid; See also in general Stefania P.S. Rossi, *Stefania P. S. Rossi and Roberto Malavasi on Financial Crisis, Bank Behaviour and Credit Crunch* (1st edn, Springer 2016)

[951] Alfred F. Conard, 'A Behavioral Analysis of Directors' Liability for Negligence' (1972) Duke L J 904

Bainbridge has also pointed out that judicial intervention brings in a negative impact on the board's internal dynamics[952] which would lead to 'team production problems'[953] that ultimately affect the business performance of the company. Thus, judicial intervention would not be preferred by shareholders in general. And as mentioned earlier on in this chapter, the disruption of board's internal dynamics caused in the absence of judicial or legislated deference has been indirectly echoed by the UK judges such as Lord Reed in *Wishart v Castlecroft Securities Ltd*;[954] and Newey J in *Kleanthous v. Paphiti* [2011] who, for instance, quoted Lord Reed's statement in *Wishart* case:[955]

A hypothetical director acting in accordance with section 172, and considering whether to commence legal proceedings, could ordinarily be expected to have regard to a range of factors, including … the disruption caused to the company's business, and potential risks to reputation and business relationships.[956]

And went on to conclude that the argument that the continuing of the derivative suit will cause 'disruption to business, reputation and relationships'[957] bears 'much force'[958] in favour of the discontinuation of the derivative claim.[959]

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[952] Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Van L Rev, 124
[953] ibid
[954] [2009] CSIH 63 [37] (CSIH) as cited by Newey J in *Kleanthous v. Paphitis* [2011] EWHC 2287 (Ch) [71], [72] & [73]
[955] ibid
[956] *Wishart v Castlecroft Securities Ltd* [2009] CSIH 63 (CSIH) [37] as cited by Newey J in *Kleanthous v. Paphitis* [2011] EWHC 2287 (Ch) [71]
[957] ibid [72]

SUMMARY

The protection by way of judicial or legislated deference in favour of company directors within the context of the Non-Programmed (Creative) Business Decisions cannot be considered as a threat to shareholders' interests.

As mentioned in Chapter Three, company directors' business creativity is significant to the success of the company, and from a psychology perspective, such creativity has to be motivated by way of judicial or legislated deference. This is in line with the reality that share investors in general do recognize and prefer the risk elements that associate with shares. The investment choices are widely available in the financial market and the investors, through the acquisition of shares, are entering into the contractual relationships with companies on voluntary basis. The financial investment market offers financial instruments that are considered to be less risky than shares, such as government bonds which are more suitable than shares to the risk adverse inventors.

In addition, the risk elements that associate with shares can be managed based on a diversified share portfolio.

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[958] ibid [73]

[959] Other factors such as obtaining redress by an alternative mean including the availability of unfair prejudice claim and the deemed sufficient money recoverable from the defendant directors via the shareholders' distribution also play a part in the discontinuation of the action. *Kleanthous v. Paphitis* [2011] EWHC 2287 (Ch) H12.5

Finally, the existence of judicial/legislated deference ensures that the shareholders can enjoy the freedom under the corporate democracy with the company's business being run by a board elected by the shareholders without any interference of an unelected third party.

CONCLUSION

This thesis examines, from a psychology perspective, the law relating to judicial and legislated deference in the context of company directors' business decisions. The main objective of the studies is to demonstrate that the UK judicial and legislated deference is being operated with a positive effect of motivating company directors' business creativity. This research is done with the relevant US law, providing support with a reasonable degree of comparison to achieve an in-depth understanding of how the judicial and legislated deference operate; and how both deferential approaches, from a psychology perspective, fit in line with creativity and types of business decisions.

As both the UK and the US law offer deferential protection to directors only in relation to decisions that constitute business judgments, psychology provides a solid ground on which judicial and legislated deference can be psychologically looked into by way of the theory of types of decisions, namely, programmed and non-programmed decisions. Specifically, the non-programmed decisions being

closely in line with the legal concept of business judgments, i.e., a type of business decision that qualifies for judicial and legislated deference.

However, the sole reliance of the concept of non-programmed business decisions cannot sufficiently answer the main objective of this research. Whilst the concept of non-programmed decisions reflects Novelty, it (unlike the legal requirement) does not deem the condition of decisions taken in 'good faith' as an essential component to establish the type of the decisions. To address this shortcoming, doctrine of the Product-Oriented Measure of Creativity is borrowed. The gap of the 'good faith' requirement is filled by the condition of 'usefulness' within the provision of the definition of Creativity. This ensures that one can look into company directors' business decisions in the context of the UK judicial and legislated deference from the perspectives of business novelty; good faith in the interest of the company; and the types of business decisions. This research approach enables this thesis to be written to formulate a new type of business decision specifically designed to denote directors' business judgment. This type of business decision is given the name as Non-Programmed (Creative) Business Decisions.

In addition, the psychology observation of UK judicial and legislated deference cannot be complete without looking into:

- the functional responsibilities or corporate governance functions of company directors, i.e., business decisions that are not considered by the courts as business

judgments, and therefore, judicial or legislated deference is not applicable. This thesis demonstrates that this type of business decisions can be examined psychologically by way of programmed business decisions; and

- business decisions that have been made with an element of conflict of interest or bad faith.

As the above types of business decisions would operate to disqualify directors from the protection of judicial or legislated deference due to the absence of business creativity.[960]

Finally, the demonstration of the psychology concept relating to types of business decisions within the context of the law has been undertaken by way of case studies at the end of Chapter Five.

[960] As mentioned throughout Chapters Four and Five, the condition of 'usefulness' within the definition of creativity would not be satisfied if the relevant decision is made in bad faith.

CHAPTER SIX - FINAL CONCLUSION

The thesis looks into the motivating effect of judicial and legislated deference, from a psychology perspective, on directors' business creativity. This thesis argues that company directors' business creativity, in the interest of the companies, represents the actual justification of judicial or legislated deference. In order to achieve this objective, works have been logically undertaken to demonstrate, from a broad perspective, the following:

1. Chapter Two reviews the UK law with an aim to trace the existence of judicial and legislated deference;
2. Chapter Three looks into the correct interpretation of the judges' terms, namely, 'judges are not business experts' and '… judges are ill-equipped …' leading to the conclusion that these terms cannot be taken literally. The actual meaning of these terms justifying judicial or legislated deference lies on the business creativity of company directors;
3. Chapter Four looks into the psychology theories of creativity and motivation.
4. Chapter Five looks into the types of business decisions, from a managerial psychology perspective, with the end result of formulating the theory of the type of business decisions, known as – Non-Programmed (Creative) Business Decisions.

Taking a substantive view, each of the chapters has achieved the following:

Chapter Two mapped the landscapes of judicial and legislated deference within UK company law throughout the pre- and post- Companies Act 2006 eras. The courts have adopted a different attitude towards different types of business decisions, namely, business judgements (Non-Programmed (Creative) Business Decisions); and decisions relating to corporate governance functions such as supervision and internal control. With the former type of decisions retaining the protection of judicial or legislated deference.

Derivative action initiated by company shareholders was, in common law, subject to the Wrongdoer's Control Rule. This rule insulated company directors against actions for their business judgments. Judicial deference given by the court via the Wrongdoer's Control Rule was severely limiting derivative actions almost to the point of being practically not actionable.

The Wrongdoers' Control Rule was abolished by Part 11 of the Companies Act 2006. Derivative claims can now be brought under the Act with the directors in question being protected by the deference legislated by the Act. Shareholders who initiated the derivative claim have now to satisfy the hypothetical directors' test within the provisions of sections 263(2)(a) and 263(3)(b). Under the relevant law the shareholders would have to convince the court that a hypothetical director, acting in good faith, would decide whether or not the continuing of the derivative claim would be in the interest of the company. In applying the law, the courts have adopted the

common law deferential approach[961] by calling itself of being 'ill-equipped' to interfere with the business judgments of company director.[962] This is a term which is similar to the term 'judges are not business experts' quoted in American Cases dealing with business judgment rule.[963]

The term 'ill-equipped' or 'judges are not business experts' must not be taken from the view relating to the availability of business experts within the judicial system. As Chapter Three has demonstrated that there is, in fact, no shortage of business expertise in the judicial system. These expert witnesses are available in trials to assist the judges to achieve understanding of business transactions in general. However, this does not mean that business experts can be employed as benchmarks in assessing company directors' Non-Programmed (Creative) Business Decisions. This is due to the uniqueness of this types of business decisions based on the merit of each individual case. The chapter further argues that judges, as opposed to company directors, are subject to a greater degree of bounded rationality which severely limits their capacity in judicially processing the complexity of company directors' Non-Programmed (Creative) Business Decisions. It follows that the true meaning of the terms 'judges are ill-equipped' or 'judges are not business experts' justifying judicial or legislated deference should have, and still has, been based on company directors' business creativity.

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[961] For instance, the approach taken by the judges in *Overend & Gurney v. Gibb* [1972] LR (HL) 580
[962] See for instance, *Iesini v. Westrip Holdings Ltd* [2009] EWHC (Ch) [80]
[963] See for instance, *Dodge v. Ford Motor Co* 170 NW 668 [Mich. 1919]

Business creativity is not an established concept in UK company Law. Therefore, in the absence of the definition of business creativity, it would not be possible to identify what creativity is. This lack of a suitable definition would hamper the progression in achieving the core objective of this thesis, i.e., to effectively examine the relevant law from a psychology perspective. To fill this gap, Chapter Four borrowed the psychology theory of creativity to formulate a suitable definition of business creativity.

Company directors' business creativity is significant to the interest of the companies in many different economic aspects. Chapter Four demonstrated these aspects from an economics point of view (and illustrated the economic benefits by using a number of law cases), ranging from the long-term survival of the company to the product market monopoly.

Chapter Four explored the inter-relations between creativity and motivation. This established the argument that in the absence of judicial or legislated deference, the law would be a controlling extrinsic motivator that demotivates director's business creativity at the expense of the company that they serve. Other relevant theories of motivation such as Maslow's Hierarchy of Needs have been used to further evidence the inter-connection between creativity and motivation. This strengthens the support of the necessity of judicial or legislated deference within the context of company directors' business decision-making.

As Chapter Two has pointed out the difference of company directors' business judgment and the functional responsibility relating to supervision and internal control with the former being protected by judicial or legislated deference. Chapter Five looks into the aspects of different types of business decisions, from a psychology perspective. Specifically, the concept of non-programmed business decisions is viewed closer in line with the concept of directors' business judgment. However, the sole reliance of the concept of non-programmed business decisions cannot satisfy the main objective of this thesis. This is because, whilst the concept of non-programmed business decisions reflects Novelty (one of the components within the definition of the psychology concept of creativity), it does not necessarily deem the condition requiring the decisions to be taken in 'good faith' as an essential component to establish the type of decisions, i.e., business judgments.

Therefore, to successfully examine the law relating to judicial or legislated deference within the context of directors' business decisions, Chapter Five combines the theory of the Product-Oriented Measure of Creativity with the theory of types of decisions. This combination fills the 'gap' of 'good faith' requirement by the condition of 'usefulness' within the definition of the Product-Oriented Measure of Creativity. This leads to the formulation of a specific type of business decision, i.e., business judgment. This thesis coins business judgments, from a psychology perspective, as – Non-Programmed (Creative) Business Decision.

By examining judicial and legislated deference, from a psychology perspective, based on the theories of creativity and types of decisions, this thesis has demonstrated that an appropriate psychological balance relating to directors' motivation and business creativity has been coherently maintained in the legal regime. Whereby, directors are insulated from the relevant liability within the context of Non-Programmed (Creative) Business Decisions; and not within the context of programmed business decisions.

This combined research of the relevant law with other disciplines (psychology in particular) leads to creation of a useful mechanism capable of identifying and predicting the types of business decisions for the application of judicial or legislated deference.

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